MONETARY POLICY IN A DEVELOPING ECONOMY: THE INDIAN EXPERIMENT

By

SIDDHESHWAR MITTRA

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PREFACE

When I was first confronted with the problem of selecting a topic for my dissertation, I was determined to search for some theme other than planning in India, which was my occupation in India. But after a search for a reasonable length of time I came back again to the same hard core; namely, developmental planning in an underdeveloped country like India. Perhaps in my inability to get away from planning and development I acted like a typical citizen of India. This problem is one in which everyone in India is deeply interested. Moreover, being associated with the Reserve Bank of India in a research capacity for six years during which the First Five Year Plan was completed and the Second Plan was launched, I felt better qualified to evaluate critically the role of the Reserve Bank in the development of the country. Consequently, I decided to make it the topic of my study. It may not be out of place to point out that I have made no attempts to provide a panacea for the plethora of problems with which the development planning in India is concerned.

Rather, I have come to the conclusion that there is no unique monetary policy which will suit the ever changing needs of the society. Through a method of trial and error only India has to shape her national economic policy. The Reserve Bank, which is the sole authority for the monetary policy of the country, has a very difficult role to play. On the one hand, it is vested with the primary responsibility of bringing about a sustainable economic development and, on the other, the Bank is called upon to realign the monetary policy with the national economic policy. In the end, some attempts have been made in this study to show that the Reserve Bank was largely successful in playing its difficult role.

I would like to mention that throughout the study I had ample opportunity to consult the officers of the Reserve Bank and experts on Indian economics. However, at no time did I avail myself of this opportunity so that my evaluations and judgments would be based solely upon what I had learned about Indian economics in general and the Reserve Bank in particular during my association with the Bank. I should also like to make it clear that the views expressed in this study are my own, and not those of the Reserve Bank or any other organization.

It is never easy for a research student to make a full and honest declaration of his intellectual and other debts. The list of persons to whom I am indebted is far greater than I know. As a practical matter, I can only attempt to acknowledge the more pressing debts.

I wish first to thank members of my Committee; namely, Drs. C. H. Donovan, C. A. Matthews, E. L. Jackson, and J. W. Gaddum, who have given me their help and assistance. To Messrs. K. C. Mittra and D. N. Sarkar, who assisted me with unbelievable efficiency with a constant source of valuable material from India, I owe deep gratitude. I also gratefully acknowledge the financial assistance granted me by my brother Dr. Raj Mittra, and by the College of Business Administration, University of Florida, without which this study could not have been completed. I am especially thankful to Dr. William Hugh McEniry, Dean, Stetson University, who so generously granted me sabbatical leave for the completion of this study. The contribution of my wife, who constantly gave me the sort of sympathy and encouragement every research student needs most in the turbulent course of serious writing, has been invaluable. My final thanks are to Dr. Allen Morris Sievers for his time, patience, guidance, advice, criticism, perseverance, and encouragement.

Siddheshwar Mittra

Gainesville, Florida

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CHAPTER I

INTRODUCTION

The economic policy of a nation is an ever changing concept. During the immediate postwar period in India after the issue of the British White Paper on the Employment Act, full employment became the accepted objective of economic policy in general and of credit policy in particular. More recently economic growth has been developing as an important objective of credit policy as the nation embarked on a program of planned development. Economic growth frequently enters into the economic discussions in both the developed and developing nations. For instance in the United States according to the Federal Reserve System, "the basic function of the Federal Reserve System is to make possible a flow of credit and money that will foster orderly economic growth and a stable dollar."[1] Like developed countries, underdeveloped nations also emphasize the need for development. For instance, according to the Indian Planning Commission, India urgently needs planning "to initiate simultaneously a process of all-round balanced development which would ensure a rising national income and a steady improvement in living standards over a period."[1]

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[1] Federal Reserve System, Purposes and Function, Board of Governors of the Federal Reserve System, Washington, D. C., 1954, p. 1.

Although sustained economic development is a universal objective of both developed and underdeveloped countries, the latter are more concerned with an accelerated economic development; since they have been deprived of development for such a long time, and are anxious to improve the living standards of the masses in the quickest possible time. In this context the most important monetary problem becomes one of controlling the inflationary pressures arising out of a rapid development. It is now recognized that though credit policy can play but a small part in stimulating flagging demand, "it does play an important part in controlling effective demand and in the mopping up of excess liquidity."[2] It is through its effects on the aggregate demand that the credit policy makes its contribution to economic development.

The above discussion clearly brings out the role of the central bank in accelerating economic development. It is interesting to observe that at one time it was believed central banking policies could be formulated through the mechanical application of the reserve requirements, the eligibility provisions for the discounting of commercial paper, etc. In recent years an increasing number of economists have come to believe that "the cardinal virtue of the central banker is not conservatism in techniques but rather a disposition to discover novelties and to be versatile in technique."[1] It is through constant changes in the technique of monetary management and also the development of new instruments of credit control that the central bank can help to bring about rapid development with stability.

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[1] Government of India, Planning Commission, Review of the First Five Year Plan (New Delhi: Government of India Press, May, 1957), p. 1.

[2] United Nations, Economic Bulletin for Asia and the Far East (New York: United Nations, 1956), p. 7.

The present study concerns itself with the role of the central bank in the development process of an underdeveloped country, namely, India. India provides a fascinating background for such a study, for the problems facing the Indian economy today are of such a complex nature that the answers are not readily available either in Marxian economics or the economics of Western capitalist or social democratic countries. The reason is that nowhere else is there the same combination of size, of crushing growth of numbers, a crumbling agrarian economy, a juxtaposition of the most modern and the most primitive industrial techniques, the existence of vast unemployment and underemployment, a functioning democracy in its most sophisticated form, and a planning under a federal structure.

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[1] Richard S. Sayers, Central Banking after Bagehot (Oxford: Clarendon Press, 1957), p. 33.

India also has a central bank which is, in the words of Professor Sayers, "versatile and percipient." In fact it might not be an exaggeration to say that perhaps nowhere else in the world has the central bank taken so active a part in the economic development of a country, or departed so widely from orthodox conceptions of central banking. Precisely, then, this study attempts to determine how far the Reserve Bank of India has been successful in assisting the government in accelerating the economic development in India during the period 1950-51 to 1959-60,[1] and to what extent this development has been achieved with stability.

The organization of this study takes the following course. Chapter II entitled "The Stage of Economic Development in India" attempts to determine if India is an underdeveloped country and, if so, what is the nature and extent of her underdevelopment. This chapter will also discuss some of the problems of economic development facing India.

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[1] In India, the fiscal years cover the period April to March. The period 1950-51 to 1959-60, therefore, refers to the period fiscal year 1950 through the fiscal year 1959.

The role of the central bank is primarily dependent upon the financial and banking institutions of a country. Chapter III will be devoted to the description of these institutions in India.

A criticism of the monetary policy must necessarily be based on its achievements and failures in terms of planned development of the country over a given period. Chapter IV will therefore record the planned development that took place in India during the ten-year period 1950-51 to 1959-60; that is, the period covering the last pre-Plan year (1950-51), the First Five Year Plan (1951-52 to 1955-56) and the first four years of the Second Five Year Plan (1956-57 to 1959-60). The gains of economic development will be measured in terms of such economic indicators as national income, capital formation, production, investment, and savings.

For a proper evaluation of the role of monetary policy it is both desirable and necessary to discuss the scope of monetary management as also the extent to which the monetary policy is called upon to play its role. With this objective in view chapter V will discuss the scope of monetary policy and will also record a brief history of monetary management in India.

An attempt will be made in chapter VI to build a theoretical model in terms of which the monetary policy in India will be evaluated. In doing so a distinction will be made between the long-run developmental role and the short-run restrictive role of monetary policy. Chapters VII and VIII will be devoted to the critical evaluation of the developmental and restrictive roles of monetary policy in India with a view to determining the extent of failure and success of the monetary policy in bringing about a sustainable economic development in India.

Chapter IX, the last chapter, is devised to give a brief resume of each of the earlier chapters. It will summarize the study and attempt an overall evaluation.

CHAPTER II

THE STAGE OF ECONOMIC DEVELOPMENT IN INDIA

Monetary policy plays a crucial role in shaping the economic destiny of a nation. Money and credit influence to a considerable degree the course of economic behavior. Development programs and their successful implementation largely depend upon correct and balanced policies adopted by the central monetary authority in the country. More recently greater emphasis has come to be placed on the central banks as a necessary "cog" in the machinery of monetary planning for economic growth. As Paul Einzig put it: "Economic planning is unthinkable without monetary management and monetary management is doomed to failure without economic planning."[1]

Monetary management assumes special importance in the context of the economic development of underdeveloped countries for more than one reason. In these countries, because of the inadequacy of savings and the difficulty of directing the low volume of savings into productive investment, there is usually a strong temptation on the part of the government to raise the level of investment by expanding credit. Development efforts of this nature by most of the less developed countries have in the postwar period been accompanied by inflationary price increases.[1] Whether this is inevitable and whether any relationship exists between the rate of price change and the rate of economic growth are questions subject to considerable debate on theoretical grounds. Statistical studies of the rates of growth and the rates of price change in various less developed countries have also been made to determine whether there is any systematic relationship between them, especially in the postwar period.[2] No definite answer has yet been found; however, it is widely agreed[3] that the policy of "development through inflation" in underdeveloped countries can be successful if the inflation is effectively controlled. It is in this context that the monetary policy assumes special importance.[1]

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[1] Paul Einzig, Monetary Reform in Theory and Practice (New York: MacMillan Company, 1936), p. 126.

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[1] R. J. Bhatia, "Inflation, Deflation and Economic Development," IMF _Staff Papers_, VII (1959-60), 101.

[2] For example, see "Inflation and Economic Development," _Federal Reserve Bank of New York, Monthly Review_ (August, 1959), pp. 122-27; U. Tun Wai, "The Relation between Inflation and Economic Development: A Statistical Inductive Study," IMF _Staff Papers_, VII, No. 2 (October, 1959), 310-17.

[3] Many recent studies by International Organizations have arrived at this conclusion. See, for instance, _Measures for the Economic Development of Underdeveloped Countries_ (New York: United Nations, 1951); _Economic Development with Stability_ (Washington, D. C.: International Monetary Fund, 1953).

It is important to recognize at the outset that no one type of monetary policy is suitable in all circumstances. The central monetary authority of a country has to devise a policy which will suit its country best. This, in turn, will largely depend upon the stage of the development of the country's financial institutions.

The Meaning of Economic Development

The present study proposes to evaluate the role of monetary policy in the accelerated economic development program in India under the first two government-sponsored Five Year Plans. It is therefore appropriate to state briefly in the very beginning what is meant by economic development. The stage of economic development in India can then be determined.

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[1] Creation of credit for development purposes may not become purely inflationary. Inflation for the purpose of creating useful capital is often self-destructive, since sooner or later it is likely to result in an increased supply of goods to the market. See William A. Lewis, The Theory of Economic Growth (London: G. Allen and Unwin, 1955), p. 217.

Defining economic development[1] is a difficult task.[2] The literary meaning of development is the "passage from a lower to a higher stage." However, it is extremely difficult to find a perfect definition of the term "economic." In general economic development implies an improvement in material terms; that is, in terms of the goods and services that are available to the people. But this is not enough. The effort and sacrifice that go into achieving such material improvement must also be taken into account, for more goods obtained by larger sacrifice would not necessarily involve economic development. Precisely then, obtaining "more goods and services for less [or no more] effort and

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[1] Joseph Schumpeter was the first among the modern economists to separate out economic development as a specialized area of economic analysis. This he did in his book, The Theory of Economic Development, published in German in 1911, and in English by Harvard University Press, Cambridge, Mass., in 1934.

[2] Leibenstein brings out certain difficulties in measuring economic development. For instance, he says that many patterns, and not just a constant pattern, of change are possible. Moreover, not all the variables move in the same direction. Finally, all macro-economic variables involve the difficulties inherent in the aggregation of "heterogeneous entities." Concepts like income, productivity, investment, etc. involve a very high degree of aggregation. As a consequence, there arises a problem of translating the individual entities into some common value unit. However, he concludes: "But we cannot take a perfectionist view." See Harvey Leibenstein, Economic Backwardness and Economic Growth (New York: John Wiley and Sons, 1960), pp. 8-9.

sacrifice per person,"[1] may constitute a first approximation to a definition of development as a state of the economy.

This study concerns itself with an underdeveloped country. A more explicit definition of economic development of this kind of country is therefore desirable. In underdeveloped countries the objective is to create more or less rapidly an economic situation analogous to that prevailing in the developed nations. "Essentially, the hope is to replace general poverty and near stagnation with greater affluence and cumulative enrichment."[2] How this change from the lower to the higher economic level is brought about constitutes economic development as a process over time.

It is necessary to make a further distinction between "economic development" in a special sense and the more casual use of the term to mean the kind of "economic growth" which may be merely evolutionary. Economic growth or improvement can take place gradually through autonomous improvements in production techniques, increase in savings and investment, geographical expansion, rise in the net capital formation or population increase. Economic development, as is understood here, is economic growth "of a different character." The essence of economic development in our special sense is the deliberate creation within a comparatively short period of a complex of favorable conditions, so that the economy is lifted out of the economic pit of stagnation and poverty and is able to develop sufficient motive power to go forward on its own momentum towards ever higher levels of production. Development also implies a rate of real increase of output faster than the rate of increase in population, so that the per capita income also advances along with the increment in the real national income. In short, economic development shall be taken to mean an induced increase in the real per capita income of the country (with no greater cost in terms of effort and sacrifice by the populace), at a rate promising an end of mass poverty in the foreseeable future. Manifestly, then, the problem facing modern India is one of economic development rather than mere economic growth.

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[1] Henry V. Villard, *Economic Development* (New York: Rinehart and Winston, 1960), pp. 15-16.

[2] Walter Krause, *Economic Development* (San Francisco: Wadsworth Publishing Company, 1961), p. 23.

At this stage it is pertinent to ask: "Is it possible to distinguish an underdeveloped country?" An unequivocal answer is not altogether possible; for broadly speaking, all countries, including the most advanced countries like the United States, to some degree are "underdeveloped." However economically mature a country might be, there still would exist some scope for further development.[1] However, a distinction can still be made on a relative basis between developed and underdeveloped nations by making a general study of the characteristics of nations generally recognized as underdeveloped. Let there be no misunderstanding, however. Underdeveloped regions cannot be regarded as identical. In sharp contrast they represent a group of countries with great diversity in such matters as population density and growth, political and social institutions, rates of progress, economic and physical qualities of the people and so on.[2] It is because of this diversity that a precise definition of this type of country is rendered difficult. An underdeveloped country, says Singer, "is like a giraffe -- difficult to describe but you know when you see one."[3] Concern over a precise definition of underdeveloped countries is also expressed by a group of experts appointed by the United Nations (UN). The group says:

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[1] United Nations Review (February, 1959), p. 11.

[2] See Benjamin Higgins, Economic Development (New York: W. W. Norton and Company, 1959), pp. 21-23.

[3] H. W. Singer, "Trade and Investment in Underdeveloped Areas: A Reply," American Economic Review, XLI (June, 1951), 419.

> We have had some difficulty in interpreting the term "underdeveloped countries." We use it to mean countries in which per capita real income is low when compared with the per capita real incomes of the United States of America, Canada, Australia, and Western Europe. In this sense, an adequate synonym would be "poor countries."[1]

A more meaningful, although somewhat obscure, definition is given by Jacob Viner. According to him, an underdeveloped country is one "which has good potential prospects for using more capital or more labor or more available natural resources, or all of these, to support its present population on a higher level of living, or, if its per capita income level is already fairly high, to support a larger population on a not lower level of living."[2]

While a precise definition of underdeveloped countries seems rather difficult these areas do exhibit certain common features which justify a few limited generalizations. Of necessity, however, these generalizations have to be in terms of Western economic terminology, such as low per capita income, low savings and investment, insufficient capital, etc., since appropriate terms have not so far been developed adequately to describe these areas. It is important, therefore, to remember their extreme diversity.[1] Perhaps the most satisfactory definition is given by E. M. Bernstein (a former official of the IMF) which hinges on the definition of economic development adopted above. Bernstein says:

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[1] United Nations, Measures . . . , p. 3.

[2] Jacob Viner, International Trade and Economic Development (Illinois: Free Press, 1952), p. 125.

> The best test of an underdeveloped country is its level of real income and the rate at which per capita real income is increasing. In short, an underdeveloped country is one in which output per capita is relatively low and in which productive efficiency is increasing very slowly, if at all.[2]

Thus the indicator that best describes the structural characteristics of an underdeveloped country is perhaps "per capita income." This indicator is not universally accepted, however. For instance, though the group of experts that wrote the "Measures for the Economic Development of Underdeveloped Countries"[3] agrees with Bernstein, in accepting it Viner questions the acceptability of per capita income as an index of development,[1] while Frankel[2] is overtly opposed to it. Frankel's skepticism toward the per capita income appears to be based on the existence of a large non-monetary sector in the underdeveloped countries which makes the problem of measurement of this indicator so difficult. Unlike these economists, who never reveal clearly the idea of "real" income, Kurihara makes the concept of "real per capita income" very explicit. According

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[1] For a detailed discussion, see Leibenstein, op. cit., pp. 40-41; also see Lyle W. Shannon, Underdeveloped Areas (New York: Harper and Brothers, 1957), particularly chapters I, II, V, and VI.

[2] E. M. Bernstein, "Financing Economic Growth in Underdeveloped Economies," in Walter W. Heller (ed.), Savings in the Modern Economy (Minneapolis: University of Minnesota Press, 1953), p. 267.

[3] United Nations, op. cit. The group of experts consisted of A. B. Cortez (Chile), D. R. Gadgil (India), G. Hakim (Lebanon), W. A. Lewis (England), and T. W. Schultz (US). See also Lewis, op. cit., p. 420. Some economists take a more cautious view. For instance, Higgins says: "In

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general, underdeveloped countries . . . are those with per capita incomes less than one-quarter those of the United States -- or, roughly, less than $500 per year." See Higgins, op. cit., p. 6. It is also interesting to note that some economists take the extreme view in this regard. For instance, as a footnote to chapter 2 entitled "Per Capita Output as an Index of Development," Leibenstein makes the following remark: "The reader who is convinced at the outset that per capita output is a good index of economic growth may skip this chapter." Op. cit., p. 7.

[1] Viner, op. cit., pp. 125-26.

[2] Sally H. Frankel, The Economic Impact on Underdeveloped Societies: Essays on International Investment and Social Change (Cambridge, Mass.: Harvard University Press, 1953), p. 59. Frankel remarks: "What I am concerned with is the basic implication that low or high 'incomes' per capita or low or high aggregate 'incomes' do in fact provide criteria for investment policy in relation to 'underdeveloped territories' at all. I believe it is significant that the current literature on the relation between aggregate 'income' and investment makes use of terms like gross or net national 'income' per head as if the word 'income' in such expressions has a similar connotation as a guide for investment decisions as it has, or had, in a money-exchange economy for a private entrepreneur or promoter."

to him, "the most serviceable single indicator . . . is low per capita real income."[1] (Italics supplied.) Per capita real income is important; since, according to Kurihara, there cannot be economic development if the growth of population exceeds the increase of output so that each person is worse off on the average than before. The use of low per capita real income as the indicator also has the connotation that it is individual poverty that separates an underdeveloped country from a developed nation.

A general acceptance of the concept of measuring economic development by comparing per capita income of different nations is reflected in the frequent attempts made by many organizations to determine the extent of underdevelopment in a country by applying this indicator. For instance, a United Nations study was conducted in 1949 to compare the national income per capita in United States dollars for seventy countries.[2] A comparable set of estimates for 1953 was also prepared by the Center of International Studies of the Massachusetts Institute of Technology.[3]

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[1] Kenneth K. Kurihara, The Keynesian Theory of Economic Development (New York: Columbia University Press, 1959), p.26.

[2] United Nations, National and Per Capita Incomes of Seventy Countries -- 1949 (New York: United Nations, 1950), p. 13.

[3] Reproduced in Charles P. Kindleberger, Economic Development (New York: McGraw-Hill Book Company, 1958), p. 6.

One consequence of the low level of per capita real incomes is the low rate of savings and investment. Typically, underdeveloped countries channel less than 10 per cent of their low incomes into net investment every year. Six or 7 per cent would seem to be the average figure for the underdeveloped countries in Asia. In the ECAFE (Economic Commission for Asia and the Far East) region, only Japan with a net capital formation of 20 to 26 per cent of national income, and Burma, to a lesser extent, have a rate of capital formation sufficient for improving the level of living of the population.[1] A small ratio of investment to national income permits only a small annual rise in the national income.

A low level of per capita income with a low rate of investment becomes at once the cause and the effect of what is known as the "vicious circle of poverty." Underdeveloped countries are caught in a low-saving low-income vicious circle which they are not able to break through by themselves and hence they perpetually stagnate. For instance, Samuelson writes: "They [underdeveloped countries] cannot get their heads above water because their production is so low that they can spare nothing for capital formation by which their standard of living could be raised."[1] A study prepared for an official US committee by the Center for International Studies of the Massachusetts Institute of Technology (MIT) also expresses similar views. The study states:

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[1] United Nations, Economic Bulletin for Asia and the Far East (New York: United Nations, 1954), p. 1.

> The general scarcity relative to population of nearly all resources creates a self-perpetuating vicious circle of poverty. Additional capital is necessary to increase output, but poverty itself makes it impossible to carry out the required saving and investment by a voluntary reduction in consumption.[2]

The widespread poverty, low levels of investment and income, and perpetual stagnation are all closely related to an important economic[3] characteristic of underdeveloped countries, namely, the predominance of agriculture. Most of these countries have a very high proportion of the population engaged in agricultural operations with the result that there is "absolute overpopulation" in agriculture. This means that a stage is reached in agricultural industry when it is possible to reduce the number of workers in agriculture and still obtain the same total output. This in turn gives rise to an entirely different kind of unemployment, known as "disguised unemployment." The term "disguised unemployment" in the context of underdeveloped areas means that the problem of unemployment in these countries primarily consists of the accumulation of labor in occupations and in types of work with extremely low or even negligible productivity. The supply of land being limited owing to a high man-land ratio, and the rate of capital formation being low, growth of population is seen as causing the onset of diminishing returns. Each successive addition to the labor force thus reduces the productivity of labor until a point is reached where the marginal productivity of labor becomes virtually zero and conceivably even negative. While this could be considered as a red signal for a developed economy the institutional framework, such as custom, conventions, and techniques, of backward countries permits the absorption of labor even beyond this point. As a result there does not exist any prima facie unemployment in the economy. In the technical sense, however, since the productivity of labor is nil and even negative the situation is analogous to a condition where unemployment does exist. This is what is known as disguised unemployment. This type of unemployment is a ubiquitous phenomenon in all sectors of the economy and is, by its very nature, conspicuous in the agricultural sector. This fact becomes all the more important when it is recalled that most backward economies are primarily agricultural in character.

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[1] Paul A. Samuelson, Economics: an Introductory Analysis (2nd ed. rev.; New York: McGraw-Hill Book Company, 1951), p. 49.

[2] Quoted by Peter T. Bauer, Some Economic Aspects and Problems of Underdeveloped Countries (Bombay: Forum of Free Enterprise, 1958), pp. 7-8.

[3] Leibenstein classifies the characteristics of underdeveloped countries into four categories, namely, (1) Economic, (2) Demographic, (3) Cultural and Political, and (4) Technological and Miscellaneous. See Leibenstein, op. cit., pp. 40-41.

Poor credit facilities and poor marketing facilities are yet another characteristic of underdeveloped economies. Domestic industry is likely in most cases to develop in response to growing local demand. This demand depends in turn to some extent on how effectively manufacturers can take their products to the consumer. Where the mass market is unduly restricted industry will find it difficult to operate at a profit because it will be unable to cut its costs by working at optimum size and with equipment which will help to reduce outlay. But the low purchasing power of the people acts as the primary deterring factor to the growth of industries. It is true that as the economic development proceeds and as new employment is created in industry more people rise in the financial scale, creating an expanding demand for manufactured goods. Nevertheless the demand for goods is still likely to be limited in most cases by the low personal incomes. Hence for them the attainable level of industrialization is not likely to be high.

There are other important characteristics of underdeveloped countries which deserve mention here. As mentioned before low savings is a common feature of these countries. A large portion of the low savings is frequently diverted from industrial and commercial undertakings into the particularly attractive avenues of real estate, speculative holdings of profitable stocks, precious jewels, and foreign assets, to the detriment of productive investment. Another important feature is the technological backwardness, which is primarily the result of the low productivity of labor and capital. The reason for such a state of affairs is twofold. First, developments in the field of technology in underdeveloped countries have been rather slow owing to their being politically dependent till recently, which seriously hampered the technical education of the people. Second, there has frequently been an unintelligent and uncritical application of the technological methods suitable for developed nations to these backward areas; the consequences have therefore been rather disappointing. Both these factors have caused technical backwardness in underdeveloped areas.

General Problems of Economic Development of Underdeveloped Areas

According to Buchanan and Ellis, in the Western world economic growth has been associated with four dynamic factors, namely, entrepreneurship; innovations and technical change; capital accumulation; and increasing specialization and exchange between persons and regions, nationally and internationally.[1] In underdeveloped areas, where the distinguishing feature is the low per capita income, economic growth has not taken place at a rapid pace. And whatever growth in the aggregate output has occurred has been matched, or more than matched, by a growth of numbers in the population. As a result, most underdeveloped regions have continued to stagnate over long periods of time.

The question as to why the dynamic factors functioning in developed nations have operated with so little force in undeveloped regions seems to be "answerable only in terms of the value scales that guide and motivate people in those societies."[2] However, the course of history now seems to be taking a definite turn. Since World War II, many of these undeveloped countries have achieved freedom from colonial powers. As the general masses of these young nations are being exposed to the remarkable growth of the developed countries, a tremendous desire to achieve higher standards of living is gathering momentum. These forces are crumbling the barriers to rapid development, and material values are replacing the aesthetic values of the people. Thus on the one hand material values are being more fully appreciated and, on the other, the intensification of the desire of better living standards is taking place: both of these, inter alia, are conducive to rapid economic development.[1]

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[1] Norman S. Buchanan and Howard S. Ellis, Approaches to Economic Development (New York: Twentieth Century Fund, 1955), p. 406.

[2] Ibid., p. 407.

The problems of economic development in underdeveloped areas are numerous and varied. Although social values are undergoing rapid transformation pre-industrial cultural patterns and institutional arrangements appear to change very slowly. Entrepreneurial skills are lacking. Institutions which could mobilize the savings of the nations for growth purposes are ill developed, and so on. A study of an overall economic development of a country will have to take into account all of these deficiencies, and conceivably many more.

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[1] Economic development is used here in the material sense.

Since our prime index of economic development is the rate of increase of real income per capita, economic development can be expressed, inter alia, "as a function . . . of the rate of new capital formation."[1] An inference that can be drawn from the foregoing is that the underdeveloped areas might improve their aggregate output mainly by means of additions to their productive capital stock,[2] and to a lesser degree by means of entrepreneurship, innovations, and increasing specialization. Furthermore, the rate of capital formation has to exceed the rate of population growth if development is to take place.

Unfortunately, in many of the underdeveloped countries savings are barely sufficient to keep up with population growth; so that a negligible amount of new capital, if any, actually becomes available to increase the end product of the economic system. How to increase the rate of capital formation has therefore become a question of great urgency.

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[1] United Nations, Measures . . ., p. 35.

[2] Capital formation is used here to mean: (1) increasing the volume of utilizable resources, such as land reclamation, roads, etc., and (2) increasing the volume of capital equipment.

The stepping up of capital formation requires an increased supply of savings. In underdeveloped countries, by definition, private savings are very limited. Due to the low level of income the propensity to consume is very high and is all the more intensified by Duesenberry's "demonstration effect."[1] According to him, an increase in consumption expenditures on ordinary goods leads to an increased contact with luxury goods. When that occurs "impulses to increase expenditure will increase in frequency, and strength and resistance to them will be inadequate. The result will be an increase in expenditure at the expense of saving."[2] In recent years, it may be noted, due to rapid international communication and contact the people in these countries have been influenced to a considerable degree by the high consumption standards of western nations. This is an additional factor leading to the lower propensity to save. Thus, on the one hand, the vast majority of the population on a low level of income have hardly the capacity to save; and on the other, their consumption pattern has a tendency to rise which sets a limit to their desire to save.

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[1] James S. Duesenberry, Income, Saving and the Theory of Consumer Behavior (Cambridge, Mass.: Harvard University Press, 1949), p. 27.

[2] Ibid.

There is an additional reason accounting for low savings that deserves special mention here. People with low incomes are more likely to save through savings banks, cooperative savings societies, mutual societies, and similar institutions.[1] Savings of these people could be augmented if more persons were employed by governments to organize savings institutions and to urge the people to step up their savings.[2] The middle classes save through such institutions and also through insurance companies and, to a lesser extent, through investment in their own enterprises or in bonds and stocks. It is also possible that organization of the stock market, where business is potentially large, might further stimulate middle-class saving. Higher income classes are not too much handicapped for lack of institutions; however, appropriate institutional developments can still divert a part of their savings from less to more useful purposes and further increase their propensity to save.

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[1] United Nations, Measures . . . , p. 36.

[2] It may be argued that the ability of the people to save has to be increased before the savings institutions are developed. It is also conceivable that efforts to develop these institutions without first attempting to increase the propensity to save might divert the savings, at least in part, from more productive to less productive investments. These arguments do not, however, undermine the importance of developing savings institutions to mobilize the meager savings resources of underdeveloped countries. See, for instance, the memorandum prepared by the International Bank for Reconstruction and Development (IBRD). It says: "In low-income countries it is difficult to increase the volume of current domestic saving. Much can be done, however, to institutionalize saving . . . " Quoted by United Nations, Methods of Financing Economic Development in Underdeveloped Countries (New York: United Nations, 1949), p. 6.

In most underdeveloped countries savings institutions, widespread banking habits, and developed money and capital markets are seriously lacking. Consequently whatever little savings do exist have a tendency to go either into hoards of gold or foreign exchange, or else into a limited range of investments.[1] Thus malinvestment of savings becomes an important problem in these countries.[2]

Not only is it hard substantially to increase savings in countries where the standard of living is very low, but also a compulsory reduction of consumption by means of taxation is unpopular and impractical.[1] In underdeveloped countries where people are organized to protect their standard of living it is unlikely that they will permit the government to increase the rate of taxation. And even where such an organization does not exist, because of the extreme poverty of the masses an increase in the tax revenue is very unlikely without

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[1] It is estimated that in underdeveloped countries private gold hoards are as large as 10 per cent of the national income. Moreover, investments tend to be limited to land ownership and to real estate. See United Nations, Measures . . . , p. 37.

[2] One must not emphasize too heavily, however, the lack of savings as a result of the absence of savings institutions. Viewed differently, lack of savings institutions could be treated as the result of the low-savings low-investment capacity of the people.

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[1] United Nations, Measures . . . , p. 42.

The following table, which brings out the relationship between tax receipts and national income in India, only reiterates this point.

NATIONAL INCOME AND TAX RECEIPTS IN INDIA

Year	National Income Million Rupees (1)	Total Central and State Tax Receipts Million Rupees (2)	% of (1) to (2) (3)
1951-52	99,700	7,387	7.4
1952-53	98,200	6,778	6.9
1953-54	104,800	6,723	6.4
1954-55	96,100	7,204	7.5
1955-56	99,800	7,675	7.7
1956-57	113,100	8,917	7.9
1957-58	113,900	10,476	9.2
1958-59	126,000	10,898	8.6
1959-60	128,400	12,199	9.5

Source: V. K. R. V. Rao, "Relation to the National Income," Illustrated Weekly of India, LXXXII, No. 33 (August 13, 1961), 37.

making the tax rates highly progressive.[1]

If "voluntary savings" (private savings)[2] fall short of the level of savings required to step up the investment for accelerating economic development, there still remains the possibility of supplementing these savings by "forced savings" that can be made by the government.[3] Forced savings can take various forms, such as, government borrowing[4] or direct money creation to finance deliberately created budgetary deficits, foreign exchange controls and so on. In the particular case of underdeveloped economies savings by the government assume a very important form since, as mentioned above, owing to the deficient voluntary saving there frequently arises in these countries the necessity of public investment complementing private investment.

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[1] In the context of underdeveloped countries it has to be recognized that although the average per capita income is very low, the wealthier classes do possess the capacity to save. It is therefore possible for the government to tap these resources by making the tax rates steeply progressive.

[2] Taxation is treated here as a part of forced (or involuntary) savings.

[3] External assistance is not considered here as a possibility of augmenting the domestic savings.

[4] It may be noted that not all government borrowing is forced savings, since government may attract

India: An Underdeveloped Country?

A cursory glance at the Indian economy reveals that most of the characteristics of underdeveloped countries mentioned above are very applicable to India.[1] A mention has been made earlier regarding the diversity in the characteristics of underdeveloped countries. This is particularly true in the case of India. In thinking about India as an underdeveloped country, it is advantageous to think of her as two distinct sectors -- "Urban India" and "Rural India."[2]

Urban India comprises about 70 million people, or about 16 per cent of the entire Indian population. But this sector holds India's sophisticated business community with all its analysts, forecasters, investment counselors, bankers and economists. Stock exchanges in Bombay and

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voluntary savings as well. However, owing to the low levels of income of the people, the scope of such borrowing is rather limited. The reference here is particularly made to the government borrowing from the central bank.

[1] Wladimir S. Woytinsky, India: the Awakening Giant (New York: Harper and Brothers, 1957), pp. 34-55.

[2] This is also the view of Alvin H. Hansen, who spent the academic year 1958-59 as the first Yale-Ford Professor in India. See his Economic Issues of the 1960's (New York: McGraw-Hill Book Company, 1960), pp. 151-66.

Calcutta are highly developed. Big cities in India have attracted a large number of industries -- the great textile industry, the jute industry and the movie industry. There are technical schools and universities. And not to mention the least, there is a wide range of cultural activities. It is thus evident that urban India can scarcely be called underdeveloped.

Rural India, on the other hand, is indeed on the lower level of underdevelopment. Rural India, including the smaller towns, has an aggregate income of about Rs. 6,000 million to be divided among a population of some 360 million. The economic conditions existing in rural India are both deplorable and appalling.

To sum up, urban India can be better described as semideveloped, while it is rural India that makes the country as a whole unmistakably an underdeveloped country. A glimpse of the Indian economy might be helpful at this stage to determine the extent of development in both urban and rural India taken together.

At its broadest extremities India, which occupies an area of 1.3 million square miles, covers one-fifteenth of the earth's circumference. She is approximately thirteen times as large as the UK, eight times the size of Japan, but a seventh the size of the USSR.

Of India's total land area of 811 million acres only 470 million acres are cultivable. Nearly 70 per cent of both the total population and the working force are dependent on agriculture. The number of persons in India (438 million) is the second largest among the national populations of the world. The rate of increase in population is also very high (2 per cent a year) as compared to the rate of increase in the national production, which poses many economic problems.

As India covers a diversified and a large area, few generalizations hold true for every part of it. Not only do the climate, the geography and the resources vary from region to region, but the languages and customs of the people vary as well. Regional differences are themselves a prominent characteristic of the Indian economy. However, a few generalizations can be made that would be meaningful.

Agriculture is the major occupation in India, employing about 70 per cent of the labor force, and contributing towards one-half of the national income. About 40 per cent of India's exports are food and agricultural raw materials. India also relies on agricultural raw materials for some of her most important industries such as jute and cotton spinning and weaving. The main items of agricultural production in India are shown in Table 1.

TABLE 1

AGRICULTURAL PRODUCTION IN INDIA, 1950-51 AND 1959-60

In Thousands

Commodities	Units	1950-51	1955-56	1959-60
Foodgrains	(tons)	50,022	65,794	71,750
Total cereals	(tons)	41,744	64,923	60,514
Total pulses	(tons)	8,278	10,871	11,236
Non-food grains				
Sugar (cane)	(tons)	56,150	59,587	75,038
Oilseeds	(tons)	5,076	5,643	6,352
Cotton (lint)	(bales of 392 lbs.)	2,910	3,998	3,835
Jute	(bales of 400 lbs.)	3,283	4,198	4,548
Tea	(lbs.)	607,318	635,000	. .
Rubber	(lbs.)	31,829	50,000	. .

Source: Reserve Bank of India Bulletin, (October, 1960), p. 1500.

Note: . . means data not available.

The industrial revolution has just begun in India although certain industries have long been established. About one-sixth of the total national income is generated by factories and small-scale industries. However, the rural sector is fast developing as industrialization of the country takes place under the Five Year Plans. The growth of industrial production of selected commodities since 1951 is shown in Table 2.

TABLE 2

INDUSTRIAL PRODUCTION IN INDIA, 1951 AND 1960

Industry	Unit	1951	1960
Cotton Textiles			
(a) Yarn	00,000 Kgs.	493	657
(b) Cloth	00,000 Meters	3,106	3,847
Jute Textiles	000 Metric Tons	71	82
Coal	000 Metric Tons	2,905	4,384
Sugar	000 Metric Tons	94	207
Cement	000 Metric Tons	271	653
Iron and Steel	000 Metric Tons	246	533
Sewing Machines	Numbers	3,705	24,649
Automobiles	Numbers	1,856	4,305

Source: *Reserve Bank of India Bulletin* (July, 1961), Statement No. 33, p. 1142

It will be observed from the above table that the textile industry is throughout by far the largest component of the total. Other important industries are sugar, oil seeds, jute, tea and rubber products.

The foreign trade of India is small relative to the huge internal trade moving between various parts of the country. The imports and exports in India during 1950-51 and 1959-60 are shown in Table 3.

TABLE 3

INDIA'S BALANCE OF PAYMENTS, 1950-51 AND 1959-60

Million Rupees

Year	Imports (c.i.f.)	Exports (f.o.b.)	Trade Balance
1950-51	6,503	6,468	- 35
1959-60	9,237	6,233	-3,004

Source: Reserve Bank of India, Report on Currency and Finance, 1950-51 and 1959-60.

Until recently the imports and exports of India each formed about 5 per cent of the national income. The trade pattern has undergone a change in recent years, however, with industrial raw materials and capital goods figuring more prominently in imports and manufactures in exports. In recent years marginal imports of foodgrains have helped to maintain food consumption, especially in urban areas; and imports of capital goods have become essential to the country's development program. At the present time not only has the foreign trade increased quantitatively in relation to the size of the economy, but it has become a significant factor in determining the pace of development. To conclude, although "urban India" is far more developed than "rural India," India as a whole can be identified with an underdeveloped country.

The Stage of Economic Development in India

In the preceding paragraphs an attempt was made to show that India still remains an underdeveloped country. Her stage of development may now be determined. Rostow lists five stages of development; namely, the stage of the traditional society, the stage establishing the preconditions for take-off, the take-off stage, the stage of the drive to maturity and the stage of high mass consumption.[1] Any given society in a given time falls into one of these five economic stages. According to Rostow, India launched "take-off" during the 1950's.[2] It is therefore desirable to look into Rostow's take-off stage more closely.

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[1] W. W. Rostow, The Stages of Economic Growth: a Non-Communist Manifesto (London: Cambridge University Press, 1960), p. 4.

> The stage of take-off is "the interval during which the rate of investment increases in such a way that real output *per capita* rises and this initial increase carries with it radical changes in production techniques and the disposition of income flows which perpetuate the new scale of investment and perpetuate thereby the rising trend in per capita output."[1]

This stage implies five things. The "take-off," first, must be preceded by a sufficient accumulation of inner force of the system; second, the change must be conspicuous to show the characteristics of an economic revolution; third, it must culminate in self-sustained growth; fourth, take-off refers to a *stage*, which can extend over a number of years; and fifth, when a country is on the verge of passing from the take-off stage to the stage of "drive to maturity," it is in the process of what Rostow calls "break-through."

Rostow lays down the basic conditions which must be fulfilled if a country is to be classified in the take-off stage. A recent study, made by Sahota, reformulates Rostow's conditions in the following manner in order to evaluate the Indian economy vis-a-vis the stage of take-off:[2]

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[1] Rostow, "The Take-Off into Self-Sustained Growth," *Economic Journal*, LXVI (March, 1956), 25.

[2] G. S. Sahota, "Is Indian Economy in the 'Take-Off' Stage?" *Indian Economic Journal* (July, 1960), pp. 44-45.

1. Whether investment rates have risen at least to the proportion where the output consequent upon this investment is increasing at a rate higher than the rate of growth of population.

2. Whether these investment rates are high enough to create employment opportunities at a rate higher than the rate of growth of the labor force.

3. Whether these increasing investment rates are being sustained. The rule-of-thumb test for this is how far is investment being financed by domestic savings derived from current income.

4. Whether one or more new manufacturing sector(s) is (are) rapidly growing.

5. Whether built-in factors of economic development are being constructed on the side of guaranteed demand for the economy's surplus, by the growing supply-potential of investment goods. In other words, whether one or more heavy industry manufacturing sectors are rapidly developing.

6. Whether, and the extent to which, per capita income is rising.

7. Whether an entrepreneurial class is quickly emerging.

8. Whether production techniques and income flows are changing in such ways that the growing entrepreneurial section is getting control over the nation's surpluses.

9. Whether expansion of institutions is taking place conducive to high rates of investment.

Sahota examines in detail the above conditions in the light of the developments that took place in India during the ten-year period under study and comes to the conclusion that India is "doing pretty well in so far as the qualitative transformation for the 'take-off'"[1] is concerned. However, the study continues, "the slow progress, particularly in the field of domestic savings, casts doubts on the consolidation of achievements of investment rate already made, and to be used as spring-board for further progress towards the 'self-sustained' growth."[2]

In 1950 the Indian planners, independently of the Rostowian thesis and Rostow's analysis of the historical process of economic growth, planned to achieve a "self-sustained growth" in a period of 25 years or so, that is, around 1975. By the middle of the Second Five Year Plan

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[1] *Ibid.*, p. 55.

[2] *Ibid.*, pp. 55-56.

(in 1958) the Indian Planning Commission expressed doubts as to whether it was possible to continue the Plan in order to maintain the rate of growth as originally planned. After much deliberation the Second Five Year Plan was revised in 1958, bringing it down to its "hard core." In view of the slow rate of savings and investment in the Indian economy Sahota also expresses similar doubts. He concludes thus:

> . . . the current rate of saving is less than 8% of national income. In order that it should rise to 15% in the next 15 years, so as to complete the "take-off" in 25 years as was planned on the eve of the First Five Year Plan, we must generate an incremental saving rate of 47% or nearly half of every increment in income. During the last 9 years of development planning we have never been able to cross the 30% limit, while currently we seem to be saving only between 15-20% of the increments of income. Evidently, we have yet to make a "critical minimum effort" if the objective of completing the "take-off" in 25 years is to be realised.[1]

To conclude, then, India today is in the stage of Rostowian take-off. As the statistics show, she is in the very early part of the take-off stage, and doubts are being expressed by official and unofficial bodies as to whether she will be able to "break through" in 1975, as was originally planned by the Government of India.

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[1] *Ibid.*, p. 56.

It has been shown above that India belongs to the underdeveloped world, her stage of development being that of Rostow's take-off. In order to sharpen the issue, a comparison of a few selected indicators in the Indian economy with those of the USA and the UK is attempted below.

The extent of underdevelopment in India is clearly revealed in Tables 4 and 5.

TABLE 4

PER CAPITA NATIONAL PRODUCT IN SELECTED COUNTRIES, 1955

US Dollars

USA	2,343
UK	998
India	72

Source: *Foreign Aid Program*, US Senate Document No. 52, Washington, July, 1957, Table 1, pp. 239-40.

TABLE 5

NON-MONETARY MEASURES OF MATERIAL WELFARE IN SELECTED COUNTRIES, 1955

Country	Caloric Intake per Person per Day (Numbers)	Protein Consumption per Day (Grams)	Infant Mortality (No. of Deaths per 1,000 Live Births)	Literacy (Per Cent of Population 10 Years and Over)	Inhabitants per Physician (Number)
USA	3,090	92	27	98	770
UK	3,230	86	26	98	1,200
India	2,004	50	119	18	5,700

Source: Foreign Aid Program, Table 3, p. 242.

Problem of Economic Development in India

India, the massive subcontinent of Asia, is in the midst of social, economic, political and religious changes. This transformation is not just a straight and simple leap from a state of being undeveloped to that of developed. It is rather a change from an unevenly developed to a more evenly developed country.

India has the prerequisites for a rapid economic expansion. She has the natural resources on which to build an industrial society -- water power, coal, metals, fuel etc. Her land, climate and other physical resources are favorable to solve the food problem. She also has an able and experienced commercial class and an expanding technical manpower reservoir to staff a complicated technological society. In short, India has the preconditions for rapid economic development.

While on the one hand India has great potentials for development, on the other, she faces immense problems. Eighty-two per cent of the population is illiterate.[1] The population is increasing at a rate of approximately 2 per cent per annum.[2] Agriculture, in which three-fourths of the population is employed, is overmanned and underproducing, barely providing the per capita daily food. Above all, capital accumulation is too slow to finance the capital expansion that is imperative to reach a sustained industrial take-off. Some of the major problems that confront the developing India may be reviewed here briefly.

The problem of population in India in the context of her economic development is immense. According to an authoritative source[1] a country with a population growth of 1 per cent a year needs to invest something like 4 to 5 per cent of its national income merely to maintain its wealth-population ratio. An investment rate of around 8 to 10 per cent a year is required to enable a population to grow 1 per cent a year and at the same time experience an increase of something like 1 per cent a year in per capita income, unless technological progress is very great and not very capital-absorbing.

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[1] According to the 1961 census, the percentage of literacy increased to 23.6 per cent. See Reserve Bank of India Bulletin (June, 1961), p. 901.

[2] Ibid.

The number of persons in India, as mentioned earlier, is the second largest among the national populations of the world. The rate of increase in population is currently estimated to be around 2.0. per cent per annum. This means that if the economic development of some measure is to be achieved, investment will have to be made at a rate much higher than the current rate of investment. This is one of the major problems facing the country today.

India's large population also creates serious employment problems for her. At present India is faced with a seeming paradox. On the one hand there is acute and chronic unemployment; on the other, there is a severe shortage of trained men and women. Put briefly, India's population problem is one of quantity, quality and organization. Creating new employment is therefore one of the key objectives of planning in India. Heavy unemployment and underemployment in the cities and the villages are among India's most serious human and social problems. These problems need a threefold attack. First, jobs need to be created for those who each year will come of age to seek work. Second, India must develop job opportunities for those who are now unemployed, both in the cities and in rural areas. Finally, opportunities for additional work must be created for those who are underemployed, that is, those who have employment for only part of the time they wish and need to work.

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[1] Population Bulletin, XVI (March, 1960), 32.

Another important aspect of unemployment in India is the regional unemployment. In certain areas of India, chiefly those with few natural resources, or with very large populations, chronic underemployment exists, and incomes are below the all-India average. Migration of surplus labor is not a generally workable solution because of language differences and other reasons. The solution, therefore, seems to lie in the efforts to develop regional planning.

India is attempting through her government-sponsored Five Year Plans to industrialize the country. The emphasis placed on heavy and capital goods industries in the Five Year Plans, and especially in the Second Five Year Plan, poses a special problem in regard to the financing of small industries. The development of heavy industries calls for large investments but the resources of capital at the disposal of the government are low. In these circumstances it becomes necessary to economize as far as possible in the capital requirements of other types of industries and severely restrict capital investments in durable consumer goods industries. It is commonplace that large investments in heavy industries cause an increased demand for consumer goods by creating additional incomes. But these heavy industries do not produce the required consumer goods and, being capital intensive, are also unable to provide employment for the growing population. The problem therefore is twofold: first, to provide an outlet for the increasing purchasing power generated, and second, to create more employment opportunities.

A possible solution to each of the problems mentioned above is to develop some special types of industries, such as handicrafts, handloom,etc., commonly known in India as "small-scale industries." These small-scale industries require very little working capital and, primarily with the help of human labor, can produce consumer goods which can readily absorb the additional purchasing power generated by large-scale investment. However, attempts to develop small industries in turn pose two other important problems. First, a source of liberalized credit facilities for small industries has to be found. This may be done either by extending the scope of the existing institutions or by establishing new institutions. The second problem is to provide technical assistance to small industries so that these industries can grow rapidly in desired directions.[1]

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[1] According to the Reserve Bank of India, a major impediment to the development of small-scale industries in India has been the paucity of institutional credit to this sector. Though the problem has to an extent been met by the setting up of several State Financial Corporations, it has been recognized that a greater flow of credit to these industries can be facilitated only if the commercial banks with their large resources, wide branch network and local knowledge are induced to participate substantially in the financing of small industries. The reluctance of the commercial banks to enter this field has been mainly due to the larger element of risk involved in lending to small units. Consequently, the government of India formulated a Guarantee Scheme for advances to small-scale industries. This Scheme was sanctioned on an experimental basis for a period of two years and came into force in July, 1960. The objective of the Scheme was to enlarge the supply of institutional credit to

Another factor which complicates the task of development of the country is the problem of regional disparities. In India there exist great disparities not only in average income, standards of living and employment, but also in the levels of development as between different regions in the country. It is therefore imperative that in a comprehensive plan of economic development the special needs of the less developed areas have to be kept in view, so that the entire pattern of investment is adapted to the securing of a balanced regional development in the country.

The problem of a balanced development in different parts of the country can be approached in a variety of ways. First, decentralized industrial production may be set up. Second, in the location of new enterprises, whether public or private, consideration may be given to the need for developing a balanced economy for different parts of the country. Some industries may be located in particular areas in view of the availability of the necessary raw

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small-scale industrial units by granting a degree of protection to the lending institutions against possible losses in respect of such advances.

For details, see Reserve Bank of India Bulletin (June, 1960), p. 813.

materials or other natural resources. Third, steps may be taken to promote greater mobility between different parts of the country, including organization of schemes of migration and settlement from more to less densely populated areas.

A review of some of the major problems confronting India in her effort to develop the country clearly brings out one fact. These myriad problems are "two dimensional." Some of these problems are *sectoral*, while others are *aggregative*. Although the former are no less important than the latter, this study confines itself to the *aggregative* problems only.

More specifically, this study proposes to examine the aggregative problems created by an effort to achieve an accelerated development in India through government-sponsored Five Year Plans and the role of monetary policy in solving these problems.

CHAPTER III

THE BANKING AND MONETARY SYSTEM IN INDIA

An understanding of the nature and details of the banking structure and the money and capital markets in India is essential for developing the framework for evaluating the role of monetary policy in the economic development of that country. In this chapter an attempt will be made to accomplish two basic objectives: (1) description of the banking structure, (2) delineation of the money and capital markets in India.

The Banking System in India

The banking system of India is one of the most highly developed aspects of the economy. At the apex is the Reserve Bank of India which was established in 1935 as the central bank for India. Originally the Bank was fully owned by private shareholders. However, in 1948 the Bank was nationalized with the prime objective of fulfilling the need for a closer integration between its policies and those of the government. The Bank's operations are approved by the Central Board of Directors of the Bank. The Chairman of the Board is the Governor of the Reserve Bank, who is assisted by three Deputy Governors. The Governor and the Deputy Governors, it may be noted with interest, are the nominees of the central government, which makes the Bank to a considerable degree subordinate to the government.

The primary function of the Reserve Bank is to regulate the monetary system of the country so as to promote the maintenance of economic stability and also to assist the government in its task of economic development of the country. For this purpose the Bank is given the sole right of note issue. Besides, for the performance of its duties as the regulator of credit it possesses both the general and selective powers of credit control. In addition the Bank also acts as the banker to the commercial banks and to some other financial institutions including the state cooperative banks.

Since one of the primary objectives of the Reserve Bank is to assist the rapid growth of the economy, the Bank performs a variety of developmental and promotional functions. Thus the Bank actively pursues a policy for the development of an adequate and sound banking system designed not only to satisfy the needs of trade and commerce, but also of agriculture. The Bank is also responsible for expanding the facilities for industrial finance.

The balance sheet of the Reserve Bank is presented in Table 6 with a view to throwing some light on its expanding activities during the ten-year period under study. Of special interest are the items entitled "Notes in Circulation" on the liabilities side, and "Loans and Advances" on the assets side. It may be observed that over the nine-year Plan period (1950-51 to 1959-60), notes in circulation increased by Rs. 5,677 million (48.8 per cent). During the same period, loans and advances of the Reserve Bank to the government increased by Rs. 232 million (977.2 per cent), while other loans and advances of the Bank showed a much more conspicuous increase of Rs. 822 million (1213.4 per cent).

A mention may now be made of the commercial banking system in India. With the inauguration of the Reserve Bank in 1935 the commercial banks in India came to be classified into two main groups, namely, scheduled banks and non-scheduled banks. Scheduled banks are those banks

TABLE 6

SELECTED LIABILITIES AND ASSETS OF THE RESERVE BANK OF INDIA DURING SELECTED YEARS

Million Rupees

Average of Friday Figures	Notes in Circulation	Central Govt. Deposits	Foreign Assets	Loans and Advances to Govts.	Other Loans and Advances	Bills Purchased and Discounted	Total Liabilities or Assets
1950-51	11,632	1,486	8,324	24	68	31	14,994
1955-56	13,394	601	7,235	17	370	98	15,541
1959-60	17,309	555	1,966	255	889	155	22,008

Source: Reserve Bank, *Report on Currency and Finance, 1959-60*, Statement No. 33.

which are included in the second schedule to the Reserve Bank of India Act and may be broadly compared to the member banks in the USA. They are eligible for certain facilities, especially the facility of obtaining accommodation from the Reserve Bank; consequently they bear certain obligations toward the Bank. The Reserve Bank Act lays down the conditions which a bank must fulfill to qualify for the inclusion in the second schedule. These are as follows:

1. The bank must have paid-up capital and surplus of an aggregate value of at least Rs. 500,000.

2. It must satisfy the Bank that its affairs are not being conducted in a manner detrimental to the interest of its depositors.

3. It must be a company as defined in the Companies Act of 1956.

Scheduled banks are required to keep with the Reserve Bank a minimum of 5 per cent of their demand liabilities[1] and

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[1] Demand liabilities are not the same as demand deposits, for the former include besides demand deposits all other liabilities which are payable on demand, like outstanding telegraphic and mail transfers, demand drafts, that portion of the savings deposits payable on demand, overdue fixed deposits, bills payable and borrowings from banks (other than from the Reserve Bank and the State Bank) repayable on demand.

2 per cent of their time liabilities[1] as shown by their weekly returns to the Bank.[2] Scheduled banks enjoy certain facilities of the Reserve Bank, for example, the rediscounting of eligible paper, advances against approved securities, and remittances of funds at concessional rates.

At the end of March, 1960, there were 95 scheduled banks with 3,996 branches out of a total number of 444 banking companies in India with 4,862 branches. Generally speaking, scheduled banks account for by far the greater proportion of deposits and the total bank credit in India. In March, 1960, for instance, the share of these banks in the total deposits of all commercial banks was a little over 85 per cent; also in the total credit outstanding, their share was about the same. The comparative position of scheduled banks in relation to all commercial banks in India is presented in Table 7.

Scheduled banks constitute a continuous spectrum in

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[1] Time liabilities include fixed deposits, time borrowings from banks (other than the Reserve Bank and the State Bank) and other outside liabilities not payable on demand. For details, see Reserve Bank of India, Supplement to the Reserve Bank of India Bulletin (Bombay: Reserve Bank of India, February, 1961).

[2] In 1956, the Reserve Bank was empowered to increase the required reserves from 2 per cent to 5 per cent on demand liabilities and from 5 per cent to 8 per cent on time liabilities.

TABLE 7

LIABILITIES AND ASSETS OF SCHEDULED BANKS AND ALL COMMERCIAL BANKS IN INDIA DURING THE YEAR 1959-60

Million Rupees

	Aggregate Deposits Liabilities	Bank Credit	Investments in Govt. Securities	Percentage		Percentage of Scheduled Bank Deposits to Total Deposits	Percentage of Scheduled Bank Credit to All Bank Credit	Percentage of Scheduled Bank Investments to Total Investment in Govt. Securities
				(2) to (1)%	(3) to (1)%			
	(1)	(2)	(3)	(4)		(5)	(6)	(7)
Scheduled banks	16,911	9,305	6,729	55.0	39.8	86.8	83.6	92.8
All commercial banks	19,487	11,129	7,253	57.1	37.2			

Source: Reserve Bank of India Bulletin (April, 1961), pp. 576-77; 584-85.

terms of size. Among them the State Bank (formerly the Imperial Bank of India) stands in a class by itself. It is the biggest commercial bank, accounting for over 30 per cent of the net deposits of all scheduled banks. It has close association with the Reserve Bank and it acts as the agent of the Bank.

Nationalization of the Imperial Bank of India deserves special mention here. The Rural Banking Enquiry Committee, appointed in 1949, pointing out that the Imperial Bank continued to enjoy most of the benefits it had prior to inauguration of the Reserve Bank but that most of the government's powers over it had lapsed in 1934, recommended that the government should resume effective control over the Bank.[1] The Committee asserted that entrusting the government cash work and currency chests, with all the prestige and other benefits they carry, to a single commercial bank created a powerful private monopoly which could disregard the interests of the public or jeopardize the working of the other banks; consequently this monopoly should be strictly regulated by the state. The role that the Committee envisaged for the Imperial Bank was that of an auxiliary to the Reserve Bank.

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[1] Report on the Rural Banking Enquiry (Purushottamdas) Committee (Bombay: Reserve Bank of India, 1954), pp. 94-95.

The All-India Rural Credit Survey in 1955 went much further and recommended that as part of an integrated scheme for the provision of rural credit facilities the Imperial Bank and seven other "state-associated" banks, that is, banks associated with the governments of the former princely states, should be amalgamated into a single "State Bank of India," so as to create a single, strong commercial banking institution with branches all over the country. Significantly, it added that the process of integration need not end with the amalgamation of these specified banks, but might extend, if considered necessary and appropriate, to "similar compulsory amalgamation with the State Bank of India of suitable, relatively small commercial banks whose branches are so situated as to be complementary in the point of area of operation to that of the State Bank."[1] The Imperial Bank was nationalized in 1955 and with that the government assumed direct responsibility for the urgently needed extension of banking facilities. The nationalized Imperial Bank (which established a closer relationship between the Bank and a large number of branches of the State Bank spread all over the country) also provided the Reserve Bank with the means of determining more effectively credit conditions in the market. Since 1955 when the Imperial Bank was nationalized until the end of March, 1960, the State Bank opened 374 branches throughout the country.

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[1] Report of the Committee of Direction of the All-India Rural Credit Survey (Bombay: Reserve Bank of India, 1955), pp. 94-95.

Another category of scheduled banks comprises 16 foreign banks, which specialize in the finance of the foreign trade and are commonly called "exchange banks." In 1949 when the Banking Companies Act was enacted, foreign exchange business was almost a monopoly of these banks. However, over the years exchange banks have extended their activities to internal trade and industry also, and to this extent they form an integral part of the domestic banking system. In March, 1960, for instance, exchange banks had Rs. 418.5 million invested in the securities of the Government of India and their advances were Rs. 155.1 million. As against this, they tied up only Rs. 21.1 million in "foreign bills purchased and discounted."

Non-scheduled banks, as the term implies, include all banks which are incorporated companies but are not included in the Second Schedule to the Reserve Bank Act; also they have less than Rs. 500,000 of paid-up capital and surplus.[1] They are divided into four groups (called A_2, B, C and D class banks), depending upon their paid-up capital and surplus. Although these banks are not official members of the Reserve Bank, in practice many non-scheduled banks receive a number of scheduled bank privileges. Moreover, inasmuch as most of the provisions of the Banking Companies Act of 1949 apply to all banks, the distinction between scheduled and non-scheduled banks vis-a-vis the Reserve Bank is more technical than real, and is expected gradually to lose much of its importance.

While the non-scheduled banks are the most numerous group in the Indian banking system they are typically small and frequently are unit banks. Their share in the total deposits and advances of all commercial banks is less than 15 per cent. At the end of March, 1960, there were 349 non-scheduled banks with 866 offices. On that date their deposits were Rs. 501 million, while their total advances aggregated Rs. 341 million.[2]

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[1] There are some non-scheduled banks with paid-up capital and surplus above Rs. 500,000.

[2] These data relate only to reporting banks which are less than the total number of non-scheduled banks.

Commercial banks in India grant loans in the form of overdrafts and cash credits. Such loans are based on demand promissory notes, which permit the banks to control or withdraw the credit at any time. It is not uncommon for foreign firms with good credit standing to finance trading operations with funds borrowed in this manner. Commercial banks traditionally charge a much higher rate of interest on their advances than they pay on their deposits, as is evident in Table 8.

TABLE 8

MARGIN BETWEEN ADVANCES AND DEPOSIT RATES IN INDIA DURING SELECTED MONTHS

Per Cent

Half Year Ended	Deposits	Advances	Spread Between Rates on Advances and Deposits (2 - 1)
	Annual Rate of Interest (1)	Annual Rate of Interest (2)	(3)
June, 1959	2.183	5.579	3.396
Dec., 1959	2.191	5.705	3.514
June, 1960	2.072	5.781	3.709

Source: Reserve Bank of India Bulletin (October, 1960), p. 1469.

Indian banks with the exception of some of the smaller ones generally follow a conservative lending policy. A second signature is usually required even on secured loans. Much of the conservativeness of Indian banks results from their inability to ascertain credit worthiness of lenders with the same degree of certainty that is possible in more highly developed countries. Thus while the large, well-known firms have little difficulty in obtaining credit, the smaller, newer or less well-known companies experience considerable difficulty in this regard. The latter must frequently rely on the smaller banks, where the conditions of credit are easier but the rates of interest are higher.

A novel feature of Indian banking is the distribution of deposits of scheduled banks as shown in Table 9. It will be observed from Table 9 that at the end of 1959 demand deposits were about a third of the total deposits, whereas the time deposits were well over half of these deposits. The position was almost the reverse at the end of 1955. It is also evident from the table that savings deposits consistently formed about 15 per cent of total deposits.

A look into the investment portfolio of scheduled banks as revealed in Table 10 may also be desirable at this point.

TABLE 9

DISTRIBUTION OF DEPOSITS OF SCHEDULED BANKS IN INDIA DURING THE PERIOD 1955 to 1959

End of	Demand		Time		Savings		Total
	Amount Million Rupees	Percentage to Total Deposits %	Amount Million Rupees	Percentage to Total Deposits %	Amount Million Rupees	Percentage to Total Deposits %	Amount Million Rupees
1955	4,970	50.0	3,341	33.6	1,625	16.4	9,937
1956	5,221	48.6	3,690	34.3	1,837	17.1	10,748
1957	5,663	42.0	5,794	43.0	2,020	15.0	13,476
1958	5,509	35.7	7,684	49.9	2,120	14.4	15,413
1959	5,663	30.9	10,161	55.5	2,482	13.6	18,306

Source: *Reserve Bank of India Bulletin* (July, 1960), p. 949.

TABLE 10

MATURITY DISTRIBUTION OF INVESTMENTS OF SCHEDULED BANKS IN GOVERNMENT SECURITIES DURING THE PERIOD 1956 TO MARCH, 1960

Million Rupees

End of	Government Securities Maturing in						
	1 Year	1-5 Years	5-10 Years	10-15 Years	15-20 Years	Over 20 Years	Total
1956	51	1,357	1,532	664	126	48	3,778
1957	126	2,237	1,406	511	128	65	4,473
1958	578	2,688	2,573	560	130	107	6,636
1959	976	2,480	3,151	876	178	170	7,832
March, 1960	734	2,344	3,105	864	152	180	7,379
			Percentages to Total (%)				
1956	1.3	35.9	40.5	17.6	3.3	1.3	100.0
1957	2.8	50.0	31.4	11.4	2.8	1.5	100.0
1958	8.7	40.5	38.8	8.4	2.0	1.6	100.0
1959	12.5	31.7	40.2	11.2	2.3	2.2	100.0
March, 1960	9.9	31.8	42.1	11.7	2.1	2.4	100.0

Source: Reserve Bank of India Bulletin, (September, 1960), p. 1326.

It will be seen from Table 10 that the maturity pattern of investments of scheduled banks in government securities showed some marked changes over the period December, 1956, to March, 1960. The proportion of short-term government securities (that is, maturing within 5 years), which rose from 37 per cent at the end of 1956 to 53 per cent at the end of 1957, declined thereafter reaching the level of 42 per cent of the total investment at the end of March, 1960. On the other hand, the proportion of investments in medium-term securities (that is, maturing between 5 and 10 years), after declining from 40.5 per cent in 1956 to 31.4 per cent in 1957, rose to 42.1 per cent at the end of March, 1960. It is also notable that investments in securities maturing between 10 and 15 years accounted for about 12 per cent in March, 1960, as against 18 per cent in 1956, while those in the maturity range of over 15 years showed negligible percentage change (from 4.6 to 4.5 per cent) over the period December, 1956, and March, 1960.

A unique feature of Indian banking is that branch banking and unit banking have developed side by side. Although many banks in India are unit banks, they are typically small and together control only a small part of India's total banking resources. Most of India's banking business (attracting deposits and granting loans) is concentrated in a relatively small number of banking companies with numerous branches. At the end of March, 1960, there were 444 banking companies with 4,862 offices. Of the total offices, 95 scheduled banks had 3,996 offices, while non-scheduled banks numbering 349 accounted for only 866 offices. It is also interesting to note that the State Bank alone had 823 offices on that date.

Another important characteristic of the banking system is that in India the availability of credit fluctuates in accordance with the seasonal requirements of currency and credit. The year is usually divided into two seasons of fairly equal length. The "busy season," roughly covering the period of November to April, coincides with the period of greatest stringency when crops are harvested and moved. The months of May to October, known as the "slack season," on the other hand, experience easy credit conditions.

A third point of interest to us is the fact that the Indian banking system is relatively inflexible in its loan policies. Consequently during periods of rapidly rising prices credit expansion usually lags behind the rising demand for larger volume of loans. During such times and in the absence of capital the tendency is for industrialists to rely on short-term credit to finance industrial expansion, and for speculators to expand their operations by the use of bank credit. Both practices put heavy drains upon the supply of credit by commercial banks on top of the increased demand for loans which normally accompanies rising prices. Under such conditions a tightness in the credit market is reflected not only in a rise in the interest rates but to an even greater degree in the increased difficulty of obtaining credit.

For a better understanding of the banking system it is imperative that a discussion be undertaken regarding the role of the banking system in the expansion and contraction of the money supply. The creation of deposit money by the banks is basically dependent on their cash reserves, which consist of:

1. Cash in vault.

2. Balances (required reserves and excess reserves) with the Reserve Bank.

The ratio of these two items to deposit liabilities of scheduled banks is usually called, in India, the "reserve ratio." At the end of March, 1960, the reserve ratio of all scheduled banks was 8.0. This ratio may vary from bank to bank and also from time to time. If an average reserve ratio of, say, 10 per cent is assumed, the banking system will have the potentials for a multiple credit expansion to the extent of many times the extension of credit by the Reserve Bank to the commercial banks. The above statement regarding the multiple credit expansion by the banking system needs to be duly qualified. The most important factor which restricts the credit expansion is what Whittlesey calls the "external drain."[1] When the Reserve Bank extends credit of, say, Rs. 10,000 to the banking system, part of it may be drained off the banking system entirely. On the basis of the additional reserves obtained from the Reserve Bank the commercial banks can expand their credit by creating demand deposits, for example. Some of the borrowers from these banks are likely to withdraw part of their deposits in currency. Every rupee currency that is taken away from the banking system lowers the reserves of the banks, and thus checks further deposit expansion. In short, when the Reserve Bank extends credit it increases the reserves of the banking system; when currency is withdrawn from the banking system by the public it lowers the reserves of the banking system and partly destroys the power of the banks to create credit.

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[1] Charles R. Whittlesey, Principles and Practices of Money and Banking (New York: Macmillan Company, 1948), p. 121.

The important question therefore becomes: "What portion of the new credit extended by the Reserve Bank is likely to be withdrawn from the banking system?" This question in turn is closely related to the liquidity preference of the Indian people. No official studies have been made in India to determine the liquidity preference of the people under normal conditions, nor have there been any statistical studies to estimate the expansion possibilities of the banking system as a consequence of a specific addition to the reserves of the banks. However, a comparison of the total deposit money with the public (that is, demand liabilities and other deposits with the Reserve Bank) with the total money supply (that is, currency plus deposit money with the public) may give a rough approximation of the demand for currency relative to the deposit habits of the people. This comparison is shown in Table 11. This Table does suggest that in the composition of the total money supply the share of the deposit currency is small relative to Western standards and has been on the decline. This high liquidity preference of the people in favor of currency has set up a monetary pattern making a difficult

TABLE 11

RATIO OF MONEY SUPPLY TO DEPOSIT MONEY WITH THE PUBLIC DURING SELECTED YEARS

Year	Deposit Money with the Public[a] Million Rupees (1)	Money Supply with the Public Million Rupees (2)	Ratio of (1) to (2) Per Cent (%) (3)
1950-51	6,403	19,795	32.3
1955-56	6,792	21,843	31.1
1959-60	8,390	27,010	30.1

Source: Reserve Bank, Report on Currency and Finance, 1959-60, Statement No. 20.

[a] Deposit money with the public comprises demand liabilities and other deposits with the Reserve Bank.

task for the Reserve Bank to exercise an effective and prompt credit control by directly regulating the banking system.

To conclude, in India the currency in circulation forms about two-thirds of the total money supply, while the deposit money accounts for only one-third of the money supply. This makes it easier for the Reserve Bank to control the money supply by directly influencing the currency. On the other hand, however, it makes the task of the monetary authority to regulate credit creation by the banking system more difficult. To quote the Governor of the Reserve Bank:

> . . . the framework in India is not comparable, either in coverage or in the degree of integration, to that in the West. Currency is more dominant than bank credit; in 1951-52, when the First Five Year Plan was inaugurated, currency formed 67 per cent of the total money supply, and today after six years it still forms the same percentage. This sets limitations on the extent to which monetary policy of the central banking authority can make itself felt.[1]

In view of the importance of currency in circulation in the total money supply a mention may be made here of the system of note issue in India. According to the Reserve Bank of India Act, the assets against which bank notes may be issued should consist of gold coin and bullion, foreign securities, rupee coin, government of India rupee securities, and such bills of exchange and promissory notes payable in India as are eligible for purchase by the Bank. The Act originally prescribed a "proportional reserve" of gold and foreign securities against note issue whereby, of the total assets, not less than 40 per cent was to consist of gold coin and bullion and foreign securities, with the further provision that gold coin and gold bullion should always be equal to, or more than, Rs. 400 million in value.

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[1] H. V. R. Iengar, "Current Problems of Credit and Fiscal Policy" (Washington, D.C.: Privately Printed, 1957), p. 9. (Speech delivered at the Twelfth Annual Meeting of the Board of Governors of the IBRD and the IMF at Washington, D.C., September 27, 1957.)

In 1956 in anticipation of a large expansion of currency under the impetus of the development plans, the Reserve Bank of India (Amendment) Act was passed which established the "fixed minimum" for note issue. The 1956 Act provided for a reserve consisting of Rs. 4,000 million in foreign securities and Rs. 1,150 million in gold coin and bullion, or a total of Rs. 5,150 million. The provisions regarding the maintenance of assets were further amended in October, 1957, to prescribe that the aggregate value of gold coin, gold bullion, and foreign securities held by the Reserve Bank should not be less than Rs. 2,000 million; of this, the value of gold should not be less than Rs. 1,150 million. In short, these amendments to the Reserve Bank Act paved the way for a less restricted expansion in currency.

Money and Capital Markets in India

The money market

In the broad sense money market includes, *inter* *alia*, financial institutions like investment banks, insurance companies and other long-term financing agencies. However, the more ordinary usage of the term "money market" is generally restricted to borrowing and lending of short-term funds. In India money market is defined as the "centre for dealings, mainly of short-term character, in monetary assets; it meets the short-term requirements of borrowers and provides liquidity or cash to the lenders."[1]

The outstanding characteristic of the Indian money market is its dichotomy into what may broadly be termed a developed market and an undeveloped or *bazāar* market, with a divergence in the structure of interest rates in the two markets. The developed market comprises the Reserve Bank, the State Bank, the exchange banks, and other Indian banking companies; while the unorganized market is primarily made up of indigenous bankers and, next in importance, moneylenders. The cooperative institutions occupy a somewhat intermediate position between the developed and the undeveloped sectors of the money market.

In the undeveloped sector there is no clear demarcation between short-term and long-term finance, nor even between the purposes of finance, inasmuch as there is usually nothing on a hundi (that is, the indigenous bill of exchange) to indicate whether it is for financing trade or for providing financial accommodation; in other words, whether it is a genuine trade bill or financial paper.[1] However, even in the undeveloped sector of the market some established practices are followed; as such it would be erroneous to call this sector totally undeveloped. A detailed analysis of each of the components of this sector of the market is undertaken below.

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[1] Reserve Bank of India, *Functions and Working* (Bombay: Reserve Bank of India, 1959), pp. 21-22.

The chief source of the supply of credit in the undeveloped sector of the market is what is known as "indigenous bankers." These bankers are known by different names in different parts of India. They may be individual, proprietory, or partnership banks which usually render normal banking services, including the purchasing or discounting of local bills of exchange. They provide finance for traders and small manufacturers on the basis of simpler and less formal requirements than are typical of the joint-stock banks. Indigenous banks are, however, frequently linked to the joint-stock banks through their dependence on them for loans and the discounting of bills.

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[1] Ibid., p. 23.

It is interesting to note that despite a rapid development of organized banking and cooperative credit during the last twenty-five years in India indigenous bankers still retain a significant place in the Indian money market. The main characteristics which distinguish them from organized banks are informality in dealings, direct personal contact with customers, a simple primitive (single-entry) system of accounts, and the combination of banking or money lending with other business. It is on account of these characteristics that indigenous bankers (and moneylenders) have not yet been integrated with the organized money market.

Indigenous bankers provide finance to the smaller industrialists and traders in urban areas who are not regarded as credit worthy by banks. They discount their indigenous bills (hundis) and advance loans against stocks or bullion or on personal security. These banks do not provide direct finance to agriculturists except in the case of larger landholders. They primarily finance the movement of crops by lending money to local merchants and moneylenders, who in turn finance the agriculturists.

The larger indigenous bankers who are on the approved list of scheduled banks, including the State Bank of India, borrow from them either against promissory notes bearing the signature of two indigenous bankers or by rediscounting "usance" bills (multani hundis) endorsed by them. Thus, although indigenous bankers do not form an integrated group in the money market, they are indirectly connected with the banking system and form an integral part of the market in the broad sense of the term.

Various attempts have been made from time to time by the Reserve Bank to coordinate indigenous bankers with the organized sector of the market; but so far the Bank has not been fully successful in its attempts, primarily because indigenous bankers have refused to conform to the basic rules and regulations of conducting their business that the Reserve Bank has laid down.

Moneylenders also provide an important source of finance in the money market. India is primarily an agricultural country and there always exists an acute demand for funds for the marketing of crops. The indigenous bankers provide only seasonal finance for the marketing of crops, and that only indirectly through moneylenders and merchants, except in the case of very large land holders. The moneylenders, on the other hand, have direct contact with all classes of agriculturists. Besides providing finance for the marketing of crops they also extend short-term credit for seasonal requirements and long-term credit for permanent land improvement. Interestingly, these moneylenders make loans even for consumption purposes.

Mention may now be made of the development of cooperative societies in India which, as pointed out before, occupy an intermediate position between the developed and the undeveloped sectors of the market. The history of cooperative societies in India goes back to the year 1904 when, primarily to encourage the cooperative movement, the government of India enacted the Cooperative Credit Societies Act. Since then growth of these societies has been very slow, almost disappointing. In recent years, however, under the direction and initiative of the Reserve Bank rural credit has gained considerable importance and steps are continually being taken to develop cooperative banks. In fact, in recent years borrowing of cooperative banks from the Reserve Bank has exceeded that of scheduled banks, as revealed in Table 12.

The structural setup of the cooperative credit movement is federal. At the bottom there are the small primary societies established mostly in villages. Primary

TABLE 12

ADVANCES OF THE RESERVE BANK OF INDIA TO SCHEDULED BANKS AND STATE COOPERATIVE BANKS DURING SELECTED YEARS

Million Rupees

Outstanding at the End of	Scheduled Banks	State Cooperative Banks
1951-52	546	78
1955-56	638	130
1959-60	664	745

Source: *Reserve Bank of India Bulletin* (July, 1961), Statement No. 20, p. 1131.

societies within a certain district join together and form a cooperative central bank. In turn all the cooperative central banks in a state combine to form the state cooperative bank. It is really the state cooperative banks which connect the cooperative movement to the money market. They borrow funds from the Reserve Bank, commercial banks, the government, and the public; these banks advance loans to the cooperative central banks which in turn lend to primary societies. These primary societies ultimately advance money to individual borrowers.

The Reserve Bank is authorized to grant financial assistance to state cooperative banks, who are obliged to meet certain requirements in the form of deposit of a percentage of their demand and time liabilities with the Reserve Bank. The Bank provides accommodation to these banks in the form of rediscounts and advances against eligible bills, as also advances against government and trustee securities. In addition the Reserve Bank is authorized to grant medium-term loans to state cooperative banks from the National Agricultural Credit (Long-Term Operations) and the National Agricultural Credit (Stabilisation) Funds. Finally, the Reserve Bank makes agricultural finance available to the rural sector through state cooperative banks on a more liberal scale as well as cheaper rates. On March 31, 1960, aggregate liabilities of state cooperative banks amounted to Rs. 484 million and their borrowings from the Reserve Bank totaled Rs. 752 million.[1]

The developed sector of the Indian money

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[1] It may be of interest to note that in June, 1960, the Committee on Cooperative Credit was appointed by the government of India to examine the existing standards for credit limits of cooperative institutions at different levels and to make recommendations on the revision of these with a view to providing more effective credit for agricultural production plans.

Among the external resources to cooperatives, the rate of the Reserve Bank was considered to be vital to the market, which comprises the Reserve Bank, exchange banks, and other scheduled and non-scheduled banks is well knit with a high degree of integration.[1] In India the component parts of the money market may be broadly stated as follows: (1) Call Money Market, (2) Bill Market, (3) Market for Short-Term Government Securities, and (4) Market for Collateral Loans. Each of these is dealt with separately in the following paragraphs.

All important commercial banks in India (except the State Bank) borrow money from one another in the call money market[2] to meet temporary requirements. These loans are payable on call at the option of the lender, and the

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cooperative movement as, in the opinion of the Committee, it would be unrealistic to expect the cooperatives in the near future to raise the necessary resources, wholly or in bulk, from owned funds and deposits. With a view, therefore, to augmenting the supply of credit from the Bank, the Committee suggested liberalization of the existing standards adopted by the Bank for sanctioning short-term as well as medium-term credit limits to cooperative banks. See Reserve Bank of India Bulletin (July, 1960), p. 946.

[1] In certain respects, the main Indian money markets are more highly developed than those in existence in all but the most mature financial centers. See Richard S. Sayers, Banking in the British Commonwealth (Oxford: Clarendon Press, 1952), p. 203.

[2] In the New York Money Market, "call loans" refer to loans by commercial banks to stock market brokers. Regular traders in stocks usually supply the broker only with a margin to cover possible losses arising from a fall

rate for call money[1] varies between 1 and 4 per cent,[2] depending upon the season of the year. In Table 13 average money rates in selected years are recorded.

Turning to the bill market, it may be observed that prior to 1952 there was no bill market in India. The factors responsible for impeding the growth of such a market were, according to the Reserve Bank,

> . . . the lack of uniformity in drawing bills as between different parts of the country, the practice of extending credit not subject to any specified time limit but collected by travelling salesmen, the large use of cash credit as the main form of borrowing from banks which in India have a wide network of branch organization, the preference for cash transactions in certain lines of activity, the absence of adequate warehousing facilities for storing agricultural produce and the high stamp duty on usance bills.[3]

The fact that an attempt to develop a bill market

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in the value of securities, and the broker supplies the rest of the money by borrowing from banks against these securities. The Indian call money market is somewhat similar to the Federal Funds market in New York, where banks with excess reserves lend them for one day to other banks with insufficient funds.

[1] Call money rate is the rate at which banks advance their day-to-day surplus funds to other banks, bullion merchants, or stockbrokers.

[2] For details, see the respective issues of the Report on Currency and Finance.

[3] Reserve Bank, Functions and Working, p. 23.

TABLE 13

MONEY RATES IN INDIA (BOMBAY)
DURING SELECTED YEARS

Per Cent Per Annum

	Call Money Rate[a]		Deposit Rates (3 Mos.)		Deposit Rates (12 Mos.)	
	Highest	Lowest	Highest	Lowest	Highest	Lowest
1950-51	1-1/4	1/2	2-1/4	1	2	1-1/2
1955-56	3-3/8	1-1/4	3-1/2	2-1/2	3-1/4	2-1/4
1958-59	4-7/16	1	4-11/16	2-1/4	4-1/2	2

Source: Reserve Bank, Report on Currency and Finance, 1959-60, Statement No. 33.

Note: Rates for the year 1959-60 are not available.

[a] Rate at which banks advance their day-to-day surplus funds to other banks.

was made early in 1952 owes its explanation to the new monetary policy that was initiated by the Reserve Bank in November, 1951. In fact, the "Bill Market Scheme" introduced by the Bank in January, 1952, seemed more an integral part of the new monetary policy. The grant of accommodation in the busy season, since the Bank's decision in November, 1951, to refrain from the purchase of securities, had naturally become very restricted in relation to the increasing demand for funds arising out of the accelerated tempo of development and the advancing of the 1951-52 busy season. Total scheduled bank credit, which had touched Rs. 5,776 million in the first half of January, 1952, and which was expected to rise progressively, constituted 67 per cent of total demand and time liabilities -- a level regarded as considerably in excess of what was demanded by canons of prudent banking. This stringency could no longer be relieved through the unlimited purchase of government securities as was done by the Bank prior to November, 1951. At the same time the Bank had felt the responsibility to insure that legitimate demands of bona fide trade and commerce were not hampered. This dilemma was sought to be resolved, or at least obviated, by the introduction of the Bill Market Scheme. The Scheme was designed to (1) introduce credit elasticity, especially during the busy season, (2) improve the Reserve Bank's control machinery by making the Bank rate more effective, and thereby enabling it to exercise a qualitative type of control over the expansion of bank credit and vesting in it the power to meet the seasonal needs of the market independent of the gilt-edged market, and (3) create a bill market in India comparable to the bill markets in the UK and the USA, thus laying the basis for future developments in the market mechanism.

It may be noted here that the rediscounting of bills by the Reserve Bank was an insignificant aspect of its lending operations. And even in regard to advances, scheduled banks took advantage of borrowing only against government securities [Section 17(4)(a)] , which made Section 17(4)(c) (that is, advances against usuance bills) a defunct clause. Ironically, in an attempt to develop a bill market to facilitate rediscounting of bills by the central banking authority the Reserve Bank favored Section 17(4)(c), which did not refer to rediscounting of bills by the Bank but to accepting them as security against advances made by it to scheduled banks. The Scheme thus primarily sought to enlarge the list of securities acceptable under this Section rather than lay the basis for rediscounting of bills.

The salient features of the Bill Market Scheme were not novel. The Scheme followed the system that prevailed prior to the establishment of the Reserve Bank (1935), under which the Imperial Bank of India could borrow, during the busy season, funds from the Currency Department against internal bills or hundis drawn for financing bona fide trade or by conversion of advances granted for the same purpose into usance bills. Under the present Scheme the Reserve Bank decided to advance credit in the form of demand loans to "eligible" scheduled banks against the security of usance promissory notes of their constituents in a way that would satisfy the requirements of Section 17(4)(c) of the Reserve Bank of India Act. Since the Section required the Bank to accept only bills which embodied a definite currency, banks were required to convert their demand bills into time bills/notes before they could be accepted for this Scheme.

When the Scheme was first introduced it was restricted to banks with deposits of Rs. 100 million or above. While introducing the Scheme the Bank offered several inducements to popularize it. For instance, the Reserve Bank undertook to make advances under this Scheme at 0.5 per cent below the Bank rate (i.e., at 3 per cent).

The Bank also agreed to bear one-half the cost of stamp duty incurred by banks in converting demand promissory notes into usance bills. As the Scheme obtained popularity it was extended to banks with lower deposits. The concessions which were granted to popularize the Scheme in the experimental stage were later withdrawn. In fact, since May 16, 1957, when the Bank rate was raised to 4 per cent and the stamp duty on usance bills was lowered to 1/5 per cent, the effective borrowing rate under the Scheme continued to rule at 4-1/5 per cent.

The limited success that the Scheme achieved during its operation for eight years and its decreasing popularity are summarized in Table 14. In view of the declining popularity of the bill market in India it seems appropriate to conclude that "the flexible and convenient mechanism of borrowing through cash credit or overdraft arrangements remains the predominant form of borrowing; and the growth of an active bill market . . . is not likely to be reproduced on a significant scale."[1]

In the absence of a well-developed bill market, as

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[1] Ibid., p. 24. Other bankers have also expressed similar views. For instance, see M. S. Nadkarni, "The Bill Market Scheme in India: An Appraisal," Reserve Bank of India Bulletin (September, 1955), pp. 973-79.

TABLE 14

RESERVE BANK ADVANCES TO SCHEDULED BANKS UNDER BILL MARKET SCHEME DURING THE PERIOD 1952 TO 1959

Million Rupees

Period	Advances against Usance Bills under Section 17(4)(c)	Outstanding Advances under Section 17(4)(c) at the End of the Period
1952	815	10
1953	658	5
1954	1,475	29
1955	2,254	189
1956	4,368	649
1957	4,148	276
1958	1,531	36
1959	833	14

Source: Reserve Bank, *Trend and Progress in Banking in India, 1952* through *1959*.

is the case in India, a market for government securities becomes an important element in creating greater liquidity and elasticity in the money market. A ready market for government securities enables the commercial banks to sell securities from their portfolios at any time they desire, and thus add to their cash reserves.

One of the best investments for commercial banks is Treasury bills, because of their short-term nature and high liquidity. Unfortunately, like commercial bills, no true market exists for Treasury bills in India. The Reserve Bank does issue Treasury bills weekly on behalf of the government, but this is done on a small scale. At the end of March, 1960, the total amount outstanding against Treasury bills was Rs. 12,976 million. However, the total sale during the year was only Rs. 1,392 million, as against the sale of Rs. 868 million in 1958-59 and only Rs. 10 million in 1956-57.

Finally, an important segment of the money market in India is the collateral loan market. Usually 85 to 90 per cent of the loans made by scheduled banks are covered by collateral like government securities, gold and silver ornaments, stock of corporations, merchandise, and real estate. In this market most of the borrowing is done in the form of collateral loans, while other forms of borrowing are overdrafts and cash credits.

The capital market

In India, the capital market is fairly well developed. Moreover, this sector of the market is undergoing rapid transformation in view of the development plans that are being implemented which require a larger flow of long-term capital. The capital market may be discussed under three heads: (1) Managing Agency System, (2) Stock Exchanges, and (3) Industrial Finance Corporations.

The new issue market in advanced countries like the UK and the USA is characterized by such specialized institutions as Issue Houses and Investment Banks, which undertake the promotion of new companies and the underwriting and marketing of securities. In sharp contrast to advanced countries, the new issue market in India is marked by an absence of specialized institutions.

One of the special features of the Indian capital market is the managing agency system. The managing agent is defined by the Indian Companies Act as

> . . . a person, firm or company in charge of the whole or substantially the whole of the management of a company, but deriving his or its authority by virtue of the memorandum or articles of association containing the terms of such agreement. Unlike a manager, who would be administratively under the control and supervision of the directors, the latters' control over a managing agent would be exercised only in terms of the agreement.[1]

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[1] See Section 2(9A) of the Indian Companies Act, 1913 (as amended by Act XXII of 1936).

The essence of the arrangement is that the managing agent is practically in full control of the company, which he can manage without interference on the part of the board of directors or the shareholders. His tenure is often of a permanent character and he is practically irremovable. The unique system of the managing agency has resulted in the concentration in the hands of the managing agents of the functions performed separately by vendors, promoters, and managing directors in other countries. Specialized professional promoters are few in India, and even today the managing agency system accounts for an overwhelming share of promotional activity.

Today the two oldest stock exchanges, the Native Share & Stock Brokers' Association and the Ahmedabad Share & Stock Brokers' Association, are private associations recognized by the government of Bombay and functioning under a code of written rules and regulations approved by it. The other stock exchanges functioning in Ahmedabad are also organized as private associations, but they have not been recognized by the government. Most of the stock exchanges in India, established after the passing of the Indian Companies Act, 1913, have been constituted as private or public limited liability companies; for example, the Indian Stock Exchange (Bombay), the Madras Stock Exchange and the stock exchanges at Delhi, Kanpur, and Calcutta.

The Calcutta and the Bombay stock exchanges are the most important in the country. Besides dealing in the securities issued by Indian companies, the former deals in foreign securities. There is yet another special feature of these stock exchanges and the others that deserves special mention. Although government and semi-government securities, as well as the shares and debentures of companies belonging to a number of industries, are listed on the different stock exchanges, each exchange specializes in the securities issued by industries which are regionally predominant. Thus the Calcutta Stock Exchange specializes in issues of the tea, coal, and jute industries; while the Bombay Stock Exchange mainly concerns itself with issues of such industries as cotton textile, electricity, bank and insurance scrips, and so on.

One of the problems of the monetary authorities has been to develop proper financial institutions to provide medium- and long-term loans for the development of industries. In recent years the government has started, in cooperation with other financial institutions and the public, several financial institutions, the more important of which are discussed briefly in the following pages.

The Industrial Finance Corporation of India (IFC) started in July, 1948, with a paid-up capital of Rs. 50 million (subsequently increased to Rs. 500 million). It is authorized to make medium- and long-term credit more readily available to public limited companies and cooperative societies, particularly in circumstances where normal banking accommodation is inappropriate or recourse to issues in the market is impractical. The IFC is empowered to provide financial assistance to industries in one of the following ways: (1) grant loans or subscribe to debentures of industrial corporations payable within a period of 25 years against sufficient securities, (2) underwrite the issue of stocks and shares, and (3) guarantee loans floated in the market repayable within 25 years. The IFC can be granted short- and medium-term loans by the Reserve Bank. On June 30, 1960, the IFC completed twelve years of its existence. During this period the Corporation sanctioned loans amounting to Rs. 846 million. Of the 329 applications sanctioned by it, 206 applications for Rs. 596 million were in respect of new undertakings, the remaining applications pertaining to loans for renovation, modernization, and expansion. Industry-wise, the largest amount of loan was sanctioned to the sugar industry (Rs. 256 million or 30 per cent) followed by the paper, cotton textiles, and chemical industries. During the year 1959-60 the IFC sanctioned loans amounting to Rs. 78 million in respect of 28 industrial concerns.[1]

Since the purpose of the IFC is to make long-term loans to large-scale industries the government of India enacted legislation in 1951 enabling state governments to set up State Financial Corporations (SFC) on the lines of the IFC to provide medium- and long-term credit to small- and medium-sized industries which fall outside the provisions of the IFC. The Reserve Bank was authorized to grant loans to SFC also. Moreover the Bank was authorized to purchase, sell, and rediscount bills of exchange and promissory notes bearing two or more good signatures, one of them being that of the SFC, and drawn or issued for the purpose of financing the production or marketing activities of cottage and small-scale industries and maturing within twelve months. Loans sanctioned by the SFC during 1959-60 amounted to Rs. 59 million.

Another industrial corporation, the National Industrial

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[1] Reserve Bank of India Bulletin (October, 1960), p. 1494.

Development Corporation (NIDC), with an authorized capital of Rs. 10 million was set up in October, 1954. This government-owned institution was established primarily for the purpose of granting loans to jute and cotton textile industries for modernization and rehabilitation and to machine tool units for expansion. During 1959-60, the NIDC granted loans to these industries amounting to Rs. 148 million.

In view of the heavy deficit financing planned by the government of India to finance development plans it may be of some import to discuss briefly the public debt pattern in India and the role of the Reserve Bank in government borrowings.

At the end of 1959-60 the amount of outstanding public (that is, central and state) debt was 58.8 per cent of the national income (at current prices). This ratio was 29.1 per cent in 1951-52. This upward trend is a reflection of the rapid growth of public debt in recent years, which may well pose many monetary implications.

In chapter VII an attempt will be made to evaluate critically the role of the Reserve Bank in financing government deficit. At this stage only a few general observations relating to the pattern of ownership of government debt may be made.

In order to view in perspective the rapidly growing public debt it is desirable to determine the net absorption of government securities by the public,[1] and not the total amount of market borrowing by the government or the initial subscriptions of the various categories of subscribers to market loans. This way the capacity of the public to satisfy the demand for funds by the government can be easily determined. The data on the net absorption of government securities for the period 1951-52 to 1959-60 are presented in Table 15. It may be observed that during 1959-60 total net market borrowings by central and state governments in the conventional sense (that is, cash subscriptions to loans minus repayments in cash of maturing loans) amounted to Rs. 1,747 million. However, the net absorption of securities by the public was only Rs. 1,431 million.

It may be mentioned in this connection that in India

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[1] The net absorption of government securities by the public implies the cash subscriptions of the public less cash repayments to the public of maturing loans plus net open market sales by the Reserve Bank and the government operating through the cash balance investment account. For details, see "Absorption and Pattern of Ownership of Government Debt in India," Reserve Bank of India Bulletin (February, 1960), pp. 136-60.

TABLE 15

NET ABSORPTION OF GOVERNMENT SECURITIES BY THE PUBLIC DURING THE PERIOD 1951-52 TO 1959-60

Million Rupees

	Net Market Borrowings by Central and State Governments			Cash Receipts (net) from Public (excluding Reserve Bank and Govt.)	Open Market Purchases(1) or Sales (1) to Public from Bank's Investment Acct. and Central Govt. Cash Balance Investment Acct.	Net Absorption(-) of Central and State Govt. Securities by Public (4 + 5)
	Cash Receipts	Cash Payments	Net Receipts (1 - 2)			
	(1)	(2)	(3)	(4)	(5)	(6)
First Five Year Plan						
1951-52	243	492	- 249	+ 17	- 113	- 96
1952-53	158	29	+ 129	+ 129	+ 205	- 334
1953-54	604	639	- 35	+ 463	+ 342	+ 805
1954-55	1,607	500	+1,107	+ 672	+ 253	+ 925
1955-56	986	166	+ 820	+ 642	+ 289	+ 931
Total	3,598	1,827	+1,772	+1,923	+ 976	+2,899
Second Five Year Plan (four yrs.)						
1956-57	1,437	30	+1,407	+ 897	- 191	+ 706
1957-58	997	290	+ 707	+ 281	+ 852	+1,133
1958-59	2,416	148	+2,269	+1,056	+ 890	+1,946
1959-60	2,083	336	+1,747	+ 825	+ 606	+1,431
Total	6,933	804	+6,130	+3,059	+2,157	+5,216

Source: Reserve Bank of India Bulletin (March, 1961), p. 329.

it is customary for the Reserve Bank to absorb government loans either because of an inadequate public response or because of advancing central bank credit to the government. As the Reserve Bank put it:

> In a country like India, where the money market is characterized by a sharply defined seasonal pattern, it is not convenient for the Government to enter the market with new loans time and again or to keep loans on tap indefinitely. It becomes, therefore, necessary for the Reserve Bank to acquire a reasonable stock of Government securities of varying maturities for meeting the requirements of investors all the year round.[1]

The share of the Reserve Bank in the total public debt ownership may also be seen in Table 16. Of the total public debt of Rs. 25,805 million at the end of March, 1960, the Reserve Bank held a little less than one-fifth (18.1 per cent) of the debt on its own account. The Reserve Bank and government together held 28.3 per cent, commercial and cooperative banks another 28.4 per cent, and Insurance and Provident funds held 19.6 per cent of the total debt.

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[1] *Ibid.*, p. 139.

TABLE 16

PATTERN OF OWNERSHIP OF THE COMBINED CENTRAL AND STATE GOVERNMENT SECURITIES MARCH, 1959, AND MARCH, 1960

Million Rupees

	End - March			
	1959		1960	
Category	Amount	Percentage to Total (%)	Amount	Percentage to Total (%)
Governments	2,290	10.2	2,629	10.2
Reserve Bank of India (own account)	3,133	14.0	4,669	18.1
Commercial and cooperative banks	6,186	27.7	7,325	28.4
Insurance	3,085	13.8	3,344	12.9
Provident Funds	1,415	6.3	1,732	6.7
Industrial finance and state financial corporations	28	0.1	32	0.1
Reserve Bank of India (held on account of others)	392	1.8	412	1.6
Non-residents	339	1.5	345	1.3
Others (residual)	5,510	24.6	5,317	20.6
Total	22,378	100.0	25,805	100.0

Source: Reserve Bank of India Bulletin (March, 1961), p. 331.

CHAPTER IV

THE PLANNED DEVELOPMENT IN INDIA: 1950-51 THROUGH 1959-60

India's experiment in economic development stands at the center of two of the most important developments in the postwar world. One is economic -- the dominating influence in economic thought and doctrine of the idea of accelerated growth in an underdeveloped economy. The other is political -- the influence that a successful experiment in economic growth in India is likely to have on the ideological war in the political world.

Although the political setup in India and the attempt of the Indian people to establish a socialistic pattern of society have far-reaching consequences, our concern is mainly with the monetary aspects of the economic development of India. In this chapter we will discuss the economic development that took place in India during the period 1950-51 to 1959-60. For this purpose the chapter is divided into four parts: (1) a summary of the conditions that prevailed in India before the implementation of the

First Five Year Plan, (2) a discussion of the salient features of the First and Second Five Year Plans, (3) a resume of the two Five Year Plans, and (4) a review of the developments that actually took place in India during the Plan period of 1951-52 to 1959-60. The following indicators will be used: aggregate national income, per capita income, investment, savings, capital formation, and agricultural and industrial production.

Background Note to India's Economic Development[1]

India emerged from World War II with untold economic devastation. The high inflationary potential of the strained Indian economy resulted in ever rising prices with consequent deterioration in the balance of trade, worsening of the food situation, and, finally, in unfavorable repercussions on the general economic condition of the country.

But even before normal conditions were restored in the country, India was partitioned in 1947. The economic consequences of partition were very serious. Trade between India and Pakistan was disrupted. The food situation in India became problematic. But worse still, confusion and panic spread over the financial and banking sectors, leading to a wave of bank failures.

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[1] For a detailed discussion on the economic development in India in the post-war period, see N. V. Sovani, Post-War Inflation in India -- A Survey (Gokhale Institute Publications: No. 21, Poona: Gokhale Institute of Politics and Economics, 1949).

The immediate post-partition era was characterized by serious attempts of the authorities to keep the economy on an even keel. A major instrument that was frequently used was physical controls, particularly on the movement and distribution of cloth, foodgrains and sugar. In addition, political problems continued to superimpose themselves on the economic problems, thereby complicating the already troubled situation.

In 1948 the government decided to experiment with decontrol. Soon it became more and more difficult to cope with the effects of decontrol, and huge quantities of foodgrain had to be imported. This caused a drain on India's foreign exchange reserves.

The situation described above did not materially improve with the passage of time. During 1949 the authorities engaged primarily in checking the after-effects of decontrol and the inflationary tendencies set up by it. In fact, inflation continued to be the major problem confronting the economy of the country. Also, the foreign trade situation continuously deteriorated. Toward the end of the year (September, 1949), India devalued the rupee by 30.5 per cent, which only emphasized the immediate and concentrated efforts to control inflationary tendencies and also to improve the balance of payments position. As a further anti-inflationary measure an eight-point program was outlined in October. "The two main objectives of this programme were to bring about a reduction in the level of prices and an increase in the country's foreign exchange reserves."[1] In addition to the above, various other measures were also taken[2] in order to cope with the special problems facing the economy.

A closer look at the year 1950-51 at this stage might be interesting. It was the year which provided the immediate and direct background for the formulation of the First Five Year Plan, which was inaugurated during the year 1951-52. During that year India's national income (at 1948-

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[1] Reserve Bank, Report of the Central Board of Directors for the Year Ending June, 1950, p. 16.

[2] See Reserve Bank of India, Report of the Central Board of Directors for the Year Ending June, 1951, pp. 15-18.

TABLE 17

THE NATIONAL INCOME OF INDIA, 1950-51 (AT 1948-49 PRICES)

	Million Rupees	Per Cent to Total
Agriculture	43,400	49.0
Mining, manufacturing, and small enterprises	14,800	16.7
Commerce, transport, and communications	16,600	18.8
Other services	13,900	15.7
Net domestic product at factor cost	88,700	100.2
Net earned income from abroad	-200	-0.2
NATIONAL INCOME	88,500	100.0
Per capita income: Rs. 246.3		

Source: Government of India, Central Statistical Organization, Estimates of National Income, 1948-49 to 1957-58 (April, 1959), p. 22.

49 prices) was Rs. 88,500 million[1] and the per capita income stood at Rs. 246.3. Agriculture contributed 49.0 per cent of the national income, representing the agri-

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[1] During 1950-51, the national income at current prices was Rs. 95,300 million.

cultural character of the country, while the share of commerce, transport, and communications was less than 19 per cent. In that year savings and investments were at very low levels. Savings[1] in the economy formed about 7 per cent of the national income, while investment was less than 5 per cent of the national income, according to the Planning Commission's estimate.[2]

During 1950-51 industrial production declined by 1 per cent, while the fall in the output of foodgrains was much more pronounced (as was evident from a 175 per cent increase in the deficit of foodgrains). As on the one hand production showed a downward trend, on the other, inflationary pressures on the economy continued unabated.

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[1] In India, the volume of savings is calculated through the changes in financial assets and liabilities and through investment resulting from direct conversion of savings into physical assets. For this purpose the economy is divided into three sectors: (1) government, (2) corporations, and (3) households. Saving of each of these three sectors is estimated separately. See V. V. Bhatt, "Savings and Capital Formation," Economic Development and Cultural Change, VII, No. 3, Part I (April, 1959), 332-40. In India, no precise estimates, official or otherwise, are available relating to savings and investment in the economy. Whatever attempts have been made to estimate savings and investment are only rough approximations.

[2] The gap between savings and investments was primarily filled by drawing up the past accumulated foreign exchange reserves.

The wholesale prices recorded a rise of 11.8 per cent during the year ending March, 1951, while the Bombay Cost of Living Index increased by a little under 16 per cent.

Reflecting higher demand for credit, scheduled bank credit recorded an expansion of Rs. 846 million during the period 1949-50 to 1950-51 as against a contraction of Rs. 342 million in the previous year. Money supply with the public also rose by Rs. 992 million over the same period as against an actual decline of Rs. 184 million in the previous year.

During 1950-51 the balance of payments position showed an improvement, yielding a surplus of Rs. 615 million as against a deficit of Rs. 1,693 million in 1949-50. Partly as an anti-inflationary measure the budgetary position of the government showed a substantial surplus on the current account of Rs. 592 million -- the highest surplus during any year in the war and the postwar period; and although the deficit on the capital account was of a larger magnitude (Rs. 620 million) there was an overall surplus of Rs. 124 million.

To conclude, the First Five Year Plan started in a climate in which inflationary pressures continued unabated, the food shortage was still serious, and the government had to exercise considerable restraint in its spending.

Planning in India

The concept of economic planning is not new to India. As early as in 1934 the need for reconstructing the Indian economy through long-term plans was recognized.[1] Various other non-official plans, such as the Bombay Plan, the People's Plan, the Gandhian Plan, etc., were subsequently put forth, which made suggestions to industrialize the country on a private basis. However, it was not until March, 1950, that an official body -- the Planning Commission -- was set up to prepare a plan "to initiate a process of development which will raise living standards and open out to the people new opportunities for a richer and more varied life."[2] It is therefore appropriate to state that official "scientific" planning first started in India in fiscal year 1951-52 with the implementation of the First Five Year Plan (hereafter called the First Plan), followed in 1956-57 by the Second Five Year Plan (hereafter called the Second Plan).

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[1] M. Visvesvaraya, Planned Economy for India (Bangalore: Bangalore Press, 1934), pp. 1-5.

[2] Government of India, First Five Year Plan (New Delhi: Government of India, December, 1952), Vol. I, p. 1.

The main long-term objectives of planning in India are to double the real national output in less than twenty years (between 1950 and 1968), and to double the per capita real income in less than twenty-five years (between 1950 and 1974). It was assumed that the population would increase at the rate of 12-14 per cent per decade, or at an annual rate of 1.1-1.3 per cent, while the increment in the capital-output ratio will be about 2:1 in the initial years and 3.5:1 in the later stages, with a time-lag of about two years between investment and output. It is further assumed that the investment-national income ratio will rise continuously from an estimated 5 per cent in 1950 to 7 per cent in 1955, 11 per cent in 1960, 14 per cent in 1965, 16-17 per cent in 1970, and remain at that level thereafter.[1]

Within these broad long-term objectives the First Plan sought to strengthen the economy at the base: first, by repairing the damage caused by the War and partition; second, by providing certain essential social and economic overhead investment which would make rapid development possible; and third, by establishing the basic social and economic policies for economic development according to the Directive Principles of State Policy laid down in the Constitution. Among the important steps initiated during this period were the community development movement and the land reform program.

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[1] N. A. Sarma, "Economic Development in India," IMF Staff Papers, VI (1957-58), 204-5.

In continuing and further developing the approach set out in the First Plan, the Second Plan aimed at a larger increase in production, in investment, and in employment. At the same time it sought to make the economy more dynamic in terms of economic as well as social ends by the building up of basic industries and reorganization of the rural economy through agrarian reform, community development, and cooperation. The Plan placed emphasis on accelerating the rate of growth of the national economy, increasing employment opportunities, reducing disparities in income and wealth, and preventing the concentration of economic power. A cursory glance at each of the two Plans separately seems desirable at this stage.

In its final form the First Plan,covering the period April, 1951, to March, 1956, was estimated to involve a total outlay of Rs. 20,687.8 million in the public sector, or about 23 per cent of the national income for 1951-52. The broad allocation of resources between the main heads of development in the Plan is revealed in Table 18.

TABLE 18

DISTRIBUTION OF PLANNED OUTLAY DURING THE FIRST PLAN, 1951-52 TO 1955-56: PUBLIC SECTOR

Heads	Realized Outlay during 1951-52 to 1955-56	Percentage of Total Outlay
	Million Rupees	%
Agriculture and community development	3,604.3	17.4
Industry	1,730.4	8.4
Irrigation and power	5,614.1	27.2
Social services	3,398.1	16.6
Transport and communications	4,971.0	24.0
Rehabilitation	850.1	4.1
Miscellaneous	519.9	2.5
Total	20,687.8[a]	100.0

Source: Government of India, Planning Commission, The First Five Year Plan, a Summary, p. v.

[a] This was subsequently raised to Rs. 23.7 billion. However, actual spending in 1951-56 was at Rs. 19.6 billion, less than the original total.

The resources for the development program in the public sector were calculated on the basis shown in Table 19.

TABLE 19

PLANNED RESOURCES DURING THE FIRST PLAN, 1951-52 TO 1955-56: PUBLIC SECTOR

Million Rupees

Sources	First Plan Period 1951-52 to 1955-56
Public savings from:	
(a) current revenues	5,697
(b) railways	1,700
Private savings absorbed through:	
(a) loans from the public	1,150
(b) small savings and other unfunded debt	2,700
(c) deposits, funds and other miscellaneous sources (net)	1,328
External assistance	5,210
Deficit financing, etc.	2,900
Total	20,685

Source: Review of the First Five Year Plan, p. 23.

The main features of the First Plan could be stated here briefly. The Plan was primarily designed to widen the scope for public expenditure in which the emphasis was on construction or irrigation and power projects as well as on the development of productivity of agriculture through modernizing and introducing advanced techniques. Considerable emphasis was laid on the development of transport facilities and a small amount on the development of industry. The Plan did not lay down any well defined scheme for the reorganization of agricultural production. It recognized the role of the private sector in the development process and left large-scale industry, banking, and commerce generally in private hands. Also, commensurate with this view, the investment and production targets were set after taking into consideration the extent to which private industry might develop. The Plan also aimed at increasing food production within the country in addition to raising the supply of durable consumer goods.

Financing of the Plan posed certain problems, for the estimated public and private savings fell short of the Plan outlays. Based on the current outlook external assistance expected to be forthcoming over the entire Plan period was estimated at about a quarter of the total Plan, leaving an uncovered gap of Rs. 2,900 million to be filled by additional taxation, borrowing, and, as a last resort, by deficit financing. While recognizing the dangers of deficit financing, which involved the injection of additional purchasing power into the system without a simultaneous increase in the available goods and services, the government considered the above amount of deficit financing as the "safe" limit.

The First Plan, in addition to creating an atmosphere for further development, envisaged additions to the productive equipment in the public and private sectors and the consequent increase in the productive potential of the country.[1] It would thus appear that the First Plan was primarily designed to lay the foundation for future development.

The First Plan was succeeded by the Second Plan. The Second Plan, which was drafted during the concluding years of the First Plan, was inaugurated in April, 1956. The broad aim was declared that by 1976 real income per head should be raised to nearly double the 1956 figure

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[1] Government of India, First . . . , p. 7.

TABLE 20

ANTICIPATED INCREASE IN PRODUCTIVE EQUIPMENT DURING THE FIRST PLAN, 1951-52 TO 1955-56

Million Rupees

Towards adding to the stock of productive capital owned by the central and state governments	11,990
Outlay which will contribute to building up productive capital in the private sector:	
(a) Expenditure on agriculture and rural development excluding specific provision for scarcity-affected areas	2,440
(b) Loans to transport and industry	470
(c) Provision for stimulating local development (community projects and local works)	1,050
Outlay on social capital	4,250
Unclassified outlay (including provision for scarcity-affected areas)	490
Total	20,690

Source: Government of India, Planning Commission, First Five Year Plan, p. 7.

(that is, the real income at the end of the First Plan), and the proportion of national income invested in each year should be raised to 17 per cent. It was also stated that, if this rate of progress was maintained, at the end of the fifth Five Year Plan India would be able to develop on her own without external assistance.

The objectives of the Second Plan, submitted to the Parliament on May 15, 1956, were: "(a) a sizeable increase in national income so as to raise the level of living in the country; (b) rapid industrialisation with particular emphasis on the development of basic and heavy industries; (c) a large expansion of employment opportunities; and (d) reduction of inequalities in income and wealth and a more even distribution of economic power."[1]

The "substantial" increase in the national income was calculated as 25 per cent. To obtain this, at an estimated capital-output ratio of 2.3:1, total investment of the order of Rs. 72,000 million was required which incidentally was almost double that of the investment target of the First Plan. Of this, the share of the public sector was to be Rs. 48,000 million. The government's outlay on the Plan would consist of Rs. 10,000 million on current development expenditure and Rs. 38,000 million on investment. Four-fifths of the necessary resources was expected to be raised domestically. The Plan aimed at creating 10 million new full-time jobs and a large number of part-time jobs; it also expected to raise the net domestic savings from 7 per cent to 10 per cent of the national income.

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[1] Government of India, Second Five Year Plan -- A Draft Outline (New Delhi: Government of India, February, 1956), p. 7.

The Second Plan was, in a broad sense, the successor of the First Plan. Consequently any discussion of the Second Plan must inevitably bear constant references to the earlier Plan, partly to bring out clearly the enlargement of the scope of the Second Plan and partly to indicate the dissimilarities in the two Plans.

The proposed development outlay of the central and state governments in the Second Plan amounted to Rs. 48,000 million as compared with the target of Rs. 23,560 million and the actual outlay of Rs. 19,600 million under the First Plan. In Table 21 a comparison is made of the distribution of outlays in the public sector between the two Plans.

The Second Plan assigned 30.8 per cent of expenditure in the public sector to agriculture, community development, irrigation and power; 28.9 per cent to transport and communications; 21.8 per cent to social services, etc.; and 18.5 per cent to industry and mining. The corresponding percentages for the First Plan were: 43.2, 26.4, 25.4, and 5.0. Ostensibly the emphasis of planning shifted from agriculture to industry.

TABLE 21

DISTRIBUTION OF PLAN OUTLAY BY MAJOR HEADS OF DEVELOPMENT DURING FIRST AND SECOND PLANS: PUBLIC SECTOR

Million Rupees

	First Plan				Second Plan		
	Anticipated		Realized		Anticipated		Percentage increase Col.(5) over Col.(3)
	Outlay Million Rupees (1)	% of Total (2)	Outlay Million Rupees (3)	% of Total (4)	Outlay Million Rupees (5)	% of Total (6)	% (7)
A. Agriculture and community development	3,393	14.3	2,842	14.1	5,680	11.8	99.9
B. Irrigation and power	6,474	27.2	5,850	29.1	9,130	19.0	56.1
C. Industry and mining	1,882	8.0	998	5.0	8,900	18.5	791.8
D. Transport and communications	5,700	23.9	5,315	26.4	13,850	28.9	160.6
(of which railways)	(4,000)		(4,320)		(9,000)		(108.3)
E. Social services	6,328	26.6	5,119	25.4	10,440	21.8	103.9
Total	23,777	100.0	20,124	100.0	48,000	100.0	138.5

Sources: Government of India, Planning Commission, Review of the First Five Year Plan, pp. 9-10; Second Five Year Plan, p. 56.

Note: Col.(1): Outlays as revised in 1953; Col.(3): Actual for 1951-55 plus revised estimates for 1955-56; Row B: Includes multi-purpose river valley projects; Row E: Includes medical and public health, education, rehabilitation, and miscellaneous items.

Another major shift of emphasis was the enlargement of the role of the public expenditure in the implementation of the Plans, as shown in Table 22.

TABLE 22

PUBLIC AND PRIVATE INVESTMENTS IN INDUSTRY DURING FIRST AND SECOND PLANS

Million Rupees

First Plan		Second Plan	
Public Sector	Private Sector	Public Sector	Private Sector
1,700	2,300	8,900	6,200

Source: Government of India, Planning Commission, First Five Year Plan, 1952, pp. 70-71, 436.

During the Second Plan, the government's investment in the industrial sector was to be Rs. 8,900 million[1] compared with Rs. 6,200 million of private industrial investment. In the First Plan the corresponding figures were Rs. 1,700 million and Rs. 2,300 million, respectively. In terms of actual outlay this meant more than a five-fold increase in the government investment as compared to an increase of two and one-half times in the private investment from the levels of the First Plan. This "shift" was consistent with the national objective of an increased participation of the government in the nation-building task with the ultimate objective of establishing a "socialistic pattern of society" in India. In fact, in the First Plan itself the government stated:

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[1] Of the Rs. 8,900 million, Rs. 2,000 million was for development of "Village and small industries" -- mostly through government assistance to private undertakings. Another Rs. 550 million was for final assistance to private industry through the National Industrial Development Corporation, set up for that purpose by the government. On the other hand, the figure for private investment was exclusive of investment in mining, electric power generation and distribution, plantation and small-scale industries. If these factors are taken into consideration, the "shift" would not be as conspicuous as it appears to be.

> . . . in the transformation of the economy that is called for, the state will have to play the crucial role. . . . This need not involve complete nationalisation of the means of production or elimination of private agencies in agriculture or business or industry. It does mean, however, a progressive widening of the public sector and a re-orientation of the private sector to the needs of a planned economy.[1]

In short, the Second Plan clearly established its emphasis on the industrialization of the country and larger participation of the government in the planning process.

It needs to be observed here that the public investment program in the Second Plan was designed to concentrate largely on the provision of overhead capital, such as transport, power and irrigation, and basic industry. The proposed Plan outlay of Rs. 48,000 million was consequently divided, as mentioned earlier, between investment and current outlay in the proportion of Rs. 38,000 million and Rs. 10,000 million, respectively.

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[1] Government of India, First . . ., pp. 31-32.

As compared with the First Plan, the Second Plan was not only of a different character but also of a much larger magnitude, as may be seen in Table 23.

TABLE 23

TOTAL PLANNED OUTLAYS IN FIVE YEAR PLANS

Million Rupees

First Plan		Second Plan	
Public Sector	Private Sector	Public Sector	Private Sector
20,124	18,000	48,000	24,000

Source: Government of India, Planning Commission, Review of the First Five Year Plan, 1957, p. 9; Second Plan, p. 57.

The estimated changes in the magnitudes of national income, savings, investment, etc., during the Second Plan period are also illuminating. The national income, which stood at Rs. 108,000 million at the end of the First Plan, was to increase to Rs. 134,800 million at the end of the Second Plan period. Over the same period the population was expected to increase by 24 million so that the increase in the per capita income was estimated at a slower rate, from Rs. 281 to Rs. 331. Total net investment, which was expected to be Rs. 31,000 million during 1951-52 to 1955-56, was also expected to go up Rs. 62,000 million in 1955-56 to 1960-61. As a percentage to national income, investment would increase from 7.3 to 10.7 per cent over the five years, 1955-56 to 1960-61, while domestic savings would also increase almost at the same rate from 7.0 per cent to 9.7 per cent. The capital-output ratio, which formed an important basis for arriving at the Plan outlays, was assumed to be going up from 1.88:1 in the First Plan to 2.3:1 in the Second Plan.

The financing of the Second Plan is perhaps the most important aspect of the Plan from the point of view of this study. The sources for public sector programs are detailed in Table 24. A comparison of columns (2) and (3) brings out certain important points. The most conspicuous factor is the magnitude of deficit financing envisaged in the Second Plan. Originally deficit

TABLE 24

SOURCES OF FINANCE FOR PUBLIC SECTOR PROGRAMS DURING FIRST AND SECOND PLANS

Million Rupees

	First Plan		Second Plan
	Anticipated (1)	Realized (2)	Anticipated (3)
1. Savings of public authorities from current revenues	5,697	5,743	8,000
2. Savings from earnings of railways	1,700	1,154	1,500
3. Loans from the public	1,150	2,044	7,000
4. Small savings and unfunded debt	2,700	3,036	5,000
5. Deposits, funds, and other miscellaneous sources	1,328	796	2,500
6. External assistance	5,210	2,032	8,000
7. Deficit financing	2,900	5,319	12,000
8. Gap to be covered by additional domestic resources			4,000
Total	20,685	20,124	48,000

Source: *Review of the First Five Year Plan*, pp. 23, 39-40; *Second Plan*, pp. 77-78.

TABLE 24 -- Continued

Note: A. Col. 1: As envisaged in the original First Plan. When the aggregate was revised, upwards to Rs. 23,777 million, no sub-allocations were made amongst the various items.

Col. 2: Actuals for 1951-54 plus revised estimates for 1955-56.

Col. 3: The Plan did not mention how the gap of Rs. 4 billion was intended to be filled. Vaguely the intention was to step up taxation, borrowing, etc., beyond the increases envisaged in rows 1, 3, and 4.

B. Items 1 and 2 are considered public savings by the government of India.

C. Item C entitled "Deficit Financing" is the difference between proposed (or actual) expenditure and the total revenue from taxation, borrowing, special forms of savings, and external assistance.

financing of the order of Rs. 2,900 million was estimated for the whole of the First Plan period. That this limit was far exceeded is clear from the amount of the actual deficit financing (Rs. 5,319 million) resorted to by the government during the First Plan. The Second Plan estimated an amount of deficit financing of the order of Rs. 12,000 million -- more than double the actual, and more than four times the anticipated, deficit financing during the First Plan. It is also evident that despite a tremendous shortfall in external assistance (Rs. 2,032 million in place of the anticipated Rs. 5,210 million) during 1951-56, the figure of external assistance for the Second Plan was ambitiously placed at Rs. 8,000 million. Other items that deserve special mention are public loans and the mobilization of small savings. In both cases, realized amounts being slightly higher than anticipated during the First Plan, their proposed contribution to the total financial pool was considerably increased in the Second Plan period.

The Second Plan needed at least Rs. 17,000 million in foreign exchange for carrying through both government and private development programs, even after taking into account some possible reductions in government programs as originally planned. This large amount of the foreign exchange need -- about one-fourth of the total public and private cost of the Plan -- was due almost entirely to India's effort to industrialize the country in the quickest possible time. The Plan required exceptionally heavy imports of steel, machinery, power plant equipment, etc. The financial framework of the Second Plan was therefore drawn in a way to accommodate such drains on foreign exchange as were expected to develop with the implementation of the Plan.

Although the role of the public sector was greatly magnified in the Second Plan the private sector was not altogether neglected. In fact it was assigned an important role, as is evident in Table 25. As compared to Rs. 3,400 million available for industrial development in the private sector in the First Plan, the resources anticipated over the Second Plan were Rs. 6,750 million -- almost double that of the First Plan resources. A new source of funds in the Second Plan period was the amount of Rs. 550 million receivable from National Industries Corporation. Further, receipts from several other sources were estimated at much higher levels. For instance, receipts of foreign capital were estimated at Rs. 1,000 million (as against Rs. 450 million during the First Plan), while internal resources were assumed to be contributing Rs. 3,000 million -- an increase of Rs. 1,500 million from the First Plan level.

Any type of economic planning has two facets: financial planning and physical planning; and it is important to review each of the two independently. For the public and private sectors taken together, actual gains in output of some of the more important products under the First Plan and the targets of output to be attained during the Second Plan are given in Table 26.

TABLE 25

SOURCES OF FINANCE FOR INDUSTRIAL PROGRAMS DURING FIRST AND SECOND PLANS: PRIVATE SECTOR (OTHER THAN MINING, ELECTRIC POWER, PLANTATIONS, AND SMALL-SCALE INDUSTRIES)

Million Rupees

	First Plan	Second Plan
1. Funds provided through National Industries Development Corp.	. .	550
2. Loans from Industrial Finance Corp., State Finance Corps., and Industrial Credit and Investment Corp.	180	400
3. Direct and indirect loans and participation in share-capital by central and state govts.	260	200
4. Foreign capital (including suppliers' credits)	450	1,000
5. New capital issues	400	800
6. Internal resources (of enterprises available for investment)	1,500	3,000
7. Other resources, such as Excess Profits Tax Refunds, advances from managing agents, etc.	640	800
Total	3,400	6,750
Total Outlay Envisaged[a]		7,200

Source: Government of India, Planning Commission, The Second Five Year Plan, p. 405.

Note: Provision is made for items 1, 3, and part of 7 in the public sector's financial budget.

[a] New investment plus expenditure on replacements and modernization.

TABLE 26

MAIN TARGETS OF PRODUCTION AND DEVELOPMENT IN INDIA UNDER FIRST AND SECOND PLANS

	1950-51	1955-56 First Plan		1960-61 Second Plan	Percentage Increase Expected in 1960-61 over 1950-51[b]
		Estimate	Actual	Estimate	%
Agriculture					
Foodgrains (million tons)	54.0[a]	61.6	65.0	75.0	38.9
Cotton (million bales)	2.9	4.2	4.0	5.5	89.7
Jute(million bales)	3.3	5.4	4.2	5.0	51.5
Irrigation and power					
Area irrigated (million acres)	51.0	71.0	65.0	88.0	72.5
Electricity installed capacity (million kw.)	2.3	3.6	3.4	6.9	200.0
Large-scale industries					
Finished steel (million tons)	1.1	1.4	1.3	4.3	290.9
Cotton textiles (million yards)	4,618	6,400	6,550	8,500	84.1

Source: Government of India, Planning Commission, The First Five Year Plan, Second Five Year Plan, and Review of the First Five Year Plan, New Delhi, 1952, 1956, and 1957, respectively.

[a] Relates to the year 1949-50.

[b] Percentages are only anticipated, and not actual increases.

The developments that took place in the economy from the beginning of the Second Plan until about the middle of the Plan period began to show signs of strain. Observing this trend the Government of India stated:

> The publication of the Second Plan with its admittedly high targets of investment -- both in the public and in the private sector -- created a psychological climate favourable to a further spurt in investment. This, coupled with the liberalisation of import policy geared to the increasing requirements of industrial development was a material factor in causing the strain on the balance of payments, besides exerting an upward pressure on domestic prices.[1]

This meant a marked stepping up of the outlay of the Plan in financial terms. However, in view of the strain on the resources, both external and domestic, imposed by the Plan, the National Development Council of the government of India at its meeting held in May, 1958, decided that while the ceiling for total outlay, in financial terms, should remain unaltered at Rs. 48,000 million, the Plan outlay should be split up into two parts. Part A of the Plan, involving an outlay of Rs. 45,000 million, "would represent the level of outlay up to which, on the present assessment of resources, commitment might be entered into for the rest of the Plan period."[1] It would comprise, besides projects and programs directly related to the increase in agricultural production, "core projects" and projects which had reached an advanced stage. The remaining schemes were to be included in Part B of the Plan, which would be undertaken to the extent resources became available. But even the implementation of Part A would require, it was recognized, an intensified effort to mobilize the resources by additional taxation and loans.

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[1] Government of India, Appraisal and Prospects of the Second Five Year Plan (New Delhi: Government of India, May, 1958), p. 4.

Even after the revision the outlook on resources was not very bright. The estimated resources for the Second Plan still fell short of the Rs. 45,000 million of resources needed for financing only Part A of the Plan. The problem of finding the additional internal resources of the order of Rs. 2,400 million, was therefore sought to be solved in the manner outlined in Table 27.

TABLE 27

ESTIMATES OF ADDITIONAL RESOURCES DURING THE SECOND PLAN

	Million Rupees
Additional taxation	1,000
Loans and small savings	600
Economies in expenditure and collection of arrears of taxation as well as loans due	800
Total	2,400

Source: Government of India, Appraisal and Prospects of the Second Five Year Plan, May, 1958, p. 19.

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[1] Ibid., p. 1.

The First and Second Plans: a summary

The main objectives of economic planning in India are to promote rapid and balanced economic development and to obtain a social and economic order based upon the values of freedom. The First and Second Five Year Plans (1951-52 to 1960-61) were designed with these objectives in view. These Plans marked the first phase in fulfilling the economic and social objectives of India's planned development.

The First Plan aimed at strengthening the economy at the base: first, by repairing the damage caused by the War and the Partition; second, by providing certain essential social and economic overhead investments which would make rapid economic development possible; and third, by establishing the basic social and economic policies for economic development according to the Directive Principles of State Policy laid down in the Constitution.

In continuing and further developing the approach set out in the First Plan, the Second Plan aimed at a larger increase in production, in investment, and in employment. At the same time it sought to make the economy more dynamic in terms of economic as well as social ends by the building up of basic industries and the reorganization of the rural economy through agrarian reform. The Second Plan placed emphasis on accelerating the rate of growth of the national economy, increasing employment opportunities, and reducing disparities in income.

During the First Plan, owing largely to the progress in agricultural production, the national income increased by 18.4 per cent. The Second Plan represented a larger and more broad-based effort than the First Plan. During the Second Plan the emphasis shifted from agriculture to heavy industries,[1] necessitating heavy imports of machinery. This caused a rapid depletion of India's foreign exchange reserves. Foreign exchange difficulties led to the reappraisal of the Second Plan in 1958-59, the revised outlay in the public sector being placed at Rs. 45,000 million in place of Rs. 48,000 million. The increase in the national income over the first four years of the Second Plan period was 12.2 per cent. Over the nine years, 1950-51 to 1959-60, the national income (at constant prices) increased by 33.3 per cent, per capita income recording a rise of 17.3 per cent over the same period.

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[1] During the Second Plan, it was estimated that 30.8 per cent would be spent on agriculture and allied areas, while industry and mining would claim 18.5 per cent of the total outlay. The corresponding percentages for the First Plan period were 43.2 and 5.0. It is, therefore, clear that the Second Plan put much more emphasis on industry than did the First Plan.

A study of the investment pattern during the period 1950-51 to 1959-60 is essentially an examination of the two Five Year Plans. The total investment in the economy during the first two Plans was anticipated to be a little over Rs. 100,000 million; while the outlay in the public sector during the two Plans was estimated at about Rs. 65,600 million, as shown in Table 28.

Capital formation is another indicator of economic development. A rough approximation of capital formation in India during the period 1950-51 to 1959-60 out of the budgetary resources of the government of India is presented in Table 29. This Table indicates the manner in which the central government was instrumental in raising the level of capital formation more than nine times during the period 1950-51 to 1959-60, the capital formation increasing from Rs. 985 million in 1950-51 to Rs. 8,405 million in 1959-60.

TABLE 28

OUTLAY AND INVESTMENT IN FIRST AND SECOND PLANS

Million Rupees

	First Plan 1951-52 to 1955-56	Second Plan 1955-56 to 1960-61 (Anticipated)	Total 1950-51 to 1960-61 (Anticipated)
Public sector outlay[a]	19,600	46,000	65,600
Public sector investment[a]	15,600	36,500	52,100
Private sector investment	18,000[b]	31,000[b]	49,000[b]
Total investment	33,600	67,500	101,100
Total outlay	37,600	78,000	114,600

Source: *Economic Newsletter* (Embassy of India), Supplement No. 12 (June, 1960), p. 2.

[a] The term "outlay" includes expenditure for both consumption and investment.

[b] These are estimates revised in the light of fuller infomration and are in lieu of the estimates of Rs. 16,000 million in the First Plan and of Rs. 24,000 million in the Second Plan, and are exclusive of transfer from the public sector.

Note: These figures do not include investments financed out of resources transferred from the public sector.

TABLE 29

NET CAPITAL FORMATION OUT OF THE BUDGETARY RESOURCES OF THE CENTRAL GOVERNMENT DURING THE FIRST PLAN AND THE FIRST FOUR YEARS OF THE SECOND PLAN

Million Rupees

	1950-51 (Acct.)	1951-52 (Acct.)	1952-53 (Acct.)
A. Net capital formation by the central government:			
Fixed assets	492	494	432
Work stores	99	50	- 10
Increase in policy stocks of foodgrains, etc.	- 93	104	-157
TOTAL OF A	498	648	265
B. Financial assistance for net capital formation:			
To state governments	411	763	988
To non-departmental commercial undertakings	52	114	85
To others	24	106	82
TOTAL OF B	487	983	1,155
C. Total net capital formation out of the budgetary resources of the central government (A + B)	985	1,631	1,420

Source: *Eastern Economist* (Budget Number, 1960-61), March 4, 1960, p. 559.

Note: Acct. - actual budget expenditure
R. E. - revised estimate
B. E. - budget estimate

TABLE 29 -- Continued

1953-54 (Acct.)	1954-55 (Acct.)	1955-56 (Acct.)	1956-57 (Acct.)	1957-58 (Acct.)	1958-59 (R.E.)	1959-60 (B.E.)
675	868	1,278	1,837	2,029	2,346	2,760
32	- 25	51	230	372	56	- 107
-244	681	- 298	47	518	380	393
463	1,524	1,031	2,114	2,919	2,782	3,046
1,304	2,307	2,727	2,060	2,616	2,994	2,937
95	197	220	606	1,703	2,518	1,983
184	353	334	329	429	363	439
1,583	2,857	3,281	2,995	4,748	5,875	5,359
2,046	4,381	4,312	5,109	7,667	8,657	8,405

Economic Development in India during the Period 1950-51 to 1959-60

Complete and up-to-date data relating to the capital formation in India are not available. Recently, however, the Reserve Bank conducted a study with the objective of evaluating the capital formation in selected public limited companies during the calendar year 1959.[1] The findings of this study are shown in Table 30. According to this study, during 1959 the gross fixed asset formation in these 814 companies amounted to Rs. 956 million. Inventory accumulation was of the order of Rs. 77 million; thus the total gross capital formation (that is, gross fixed assets and inventories) amounted to Rs. 1,033 million. Other important items of asset formation included cash and bank balances (Rs. 124 million) and investments (Rs. 53 million).

Among the various sources of finance, fresh capital from the market amounted to Rs. 188 million. There was a net payment of borrowings from banks which partly offset the increase in other forms of borrowings; as a result the net increase in borrowings was only Rs. 27 million. Among the internal sources depreciation amounted to Rs. 477 million, while the general and other reserves contributed Rs. 360 million.

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[1] See "Capital Formation in Selected Public Limited Companies," Reserve Bank of India Bulletin (February, 1961), pp. 198-204.

The study also revealed that the rate of gross capital formation of these companies worked out at 5.7 per cent during 1959. Finally, the gross fixed assets formation took place at a rate of 7.6 per cent during the same period.

The national income of India increased from Rs. 88,500 million in 1950-51 to Rs. 117,600 in 1959-60 -- an increase of Rs. 291 million or 32.9 per cent over the nine years. The increase in agriculture over the same Plan period (Rs. 10,600 million) far exceeded the increases in mining (Rs. 4,900 million) and commerce (Rs. 5,900 million) as revealed in Table 31.

Economic gains in India in terms of savings and investment were also substantial. It should be mentioned at the outset, however, that apart from the non-availability of any precise estimates regarding savings and investment, even the factual basis for making any firm estimates is inadequate. Consequently only rough approximations are possible.

TABLE 30

SOURCES AND USES OF FUNDS OF 814 SELECTED PUBLIC LIMITED COMPANIES FOR THE YEAR 1959

Million Rupees

SOURCES OF FUNDS			
A.	1. Paid-up capital (except capitalized reserves)		188
B.	Borrowings		27
	2. From banks	-94	
	3. From industrial finance corporations	5	
	4. Other mortgages	74	
	5. Debentures	18	
	6. Others	24	
C.	7. Depreciation reserve		477
D.	8. Taxation reserve		11
E.	9. Capital reserve		-11
F.	10. General and other reserves		360
G.	11. Trade dues and other current liabilities		213
H.	12. Miscellaneous non-current liabilities		2
	13. Total[a]		1,267
USES OF FUNDS			
I.	14. Gross fixed assets		956
J.	15. Inventory		77
K.	16. Receivables		59
L.	17. Investments		53
M.	18. Advance on income tax		-1
N.	19. Miscellaneous assets		-2
O.	20. Cash and bank balances		124
	21. Total[a]		1,267

Source: *Reserve Bank of India Bulletin*, (February, 1961), p. 200.

[a] Individual items may not add up to the total because of rounding off.

TABLE 31

NET NATIONAL OUTPUT BY INDUSTRIAL ORIGIN IN INDIA DURING THE PERIOD 1950-51 TO 1959-60 (AT 1948-49 PRICES)

Million Rupees

	1950-51	1951-52	1952-53	1953-54
Agriculture	43,400	44,400	46,000	49,800
Mining, manufacturing, and small enterprises	14,800	15,200	15,800	16,500
Commerce, transport, and communications	16,600	17,300	17,900	18,300
Other services	13,900	14,300	15,000	15,700
Net domestic product at factor cost	88,700	91,200	94,700	100,300
Net earned income from abroad	-200	-200	-100	-
Net national output at factor cost = national income	88,500	91,000	94,600	100,300

Source: Reserve Bank of India Bulletin, (May, 1961), p. 829.

[a]Preliminary.

TABLE 31 -- Continued

1954-55	1955-56	1956-57	1957-58	1958-59	1959-60[a]
50,300	50,200	52,500	50,100	55,600	54,000
17,000	17,600	18,400	18,600	18,800	19,700
19,100	19,700	20,800	21,100	21,900	22,500
16,400	17,300	18,200	19,200	20,400	21,600
102,800	104,800	109,900	109,000	116,700	117,800
-	-	100	-100	-200	-200
102,800	104,800	110,000	108,900	116,500	117,600

TABLE 32

TRENDS IN THE VOLUME AND PATTERN OF SAVINGS IN INDIA DURING THE PERIOD 1950-51 TO 1958-59 (AT 1948-49 PRICES)

Million Rupees

Year	Government Sector (1)	Domestic Corporate Sector (2)	Household Sector (3)	Aggregate of All Sectors (4)	Percentage of (4) to Nat'l Income (5)
1950-51	870	300	4,740	5,910	6.7
1951-52	1,760	510	2,330	4,600	5.1
1952-53	850	40	4,750	5,640	6.0
1953-54	680	220	4,830	5,730	5.7
1954-55	880	420	6,010	7,310	7.1
1955-56	730	570	8,250	9,550	9.1
1956-57	1,250	520	7,890	9,660	8.8
1957-58	1,090	170	6,560	7,820	7.2
1958-59[a]	950	320	7,750	9,020	7.7
1950-51 to 1958-59	9,060	3,070	53,110	7.1	7.1

Source: *Reserve Bank of India Bulletin* (August, 1961), p. 1204.

[a] Data for 1959-60 are not available.

It will be seen from this table that the volume of saving (at 1948-49 prices) in the Indian economy declined from Rs. 5,910 million, or 6.7 per cent of the national income in 1950-51, to Rs. 4,600 million, or 5.1 per cent of the national income during 1951-52. Thereafter savings steadily rose during the following five years and stood at Rs. 9,660 million, or 8.8 per cent of the national income during 1956-57. However, during the year 1957-58 the volume of saving declined to Rs. 7,820 million, or 7.2 per cent of the national income, but was up again to Rs. 9,020 million in 1958-59.

As mentioned above, complete data relating to investment in India during the period under study are not available. The Planning Commission of the Government of India published data relating to public investment only under various heads for the First Plan period. In order to get a more complete estimate of investment during the period 1950-51 to 1957-58 a private study was conducted by an official of the Reserve Bank in 1959, the findings of which are summarized in Table 33. During the period 1950-51 to 1957-58 investment increased at an average annual rate of 11.8 per cent. Public investment during the same period increased at a much higher rate of 22.6 per

TABLE 33

ESTIMATES OF INVESTMENT IN INDIA DURING THE PERIOD 1950-51 TO 1957-58

(AT 1948-49 PRICES)

Million Rupees

Year	Private Investment		Public Investment	
	Amount Million Rupees	Percentage of Total Investment %	Amount Million Rupees	Percentage of Total Investment %
1950-51	4,090	70.4	1,720	29.6
1951-52	3,630	66.6	1,820	33.4
1952-53	3,730	65.4	1,970	34.6
1953-54	4,250	63.1	2,490	36.9
1954-55	4,220	52.1	3,880	47.9
1955-56	4,790	49.1	4,960	50.9
1951-52 to 1955-56	20,620	57.7	15,120	42.3
1956-57	5,940	53.8	5,100	46.2
1957-58	5,670	45.9	6,710	54.1
1950-51 to 1957-58	32,230	55.9	26,930	44.1
1958-59[b]				

Source: Economic Development and Cultural Change (April, 1959), pp. 324-25.

[a] Average rate.

[b] According to the Reserve Bank, during 1958-59 investment roughly formed 10.7 per cent of the national income. See Reserve Bank of India Bulletin (August, 1961), p. 1209.

TABLE 33 -- Continued

Total Investment		Annual Rate of Increase in Total Investment
Amount Million Rupees	Percentage of Nat'l Income %	%
5,810	6.6	
5,450	6.0	- 6.2
5,700	6.0	+ 4.6
6,740	6.7	+18.2
8,100	7.9	+20.2
9,750	9.3	+20.4
35,740	7.2	+11.4[a]
11,040	10.0	+13.2
12,380		+12.1
59,160		+11.8[a]
	10.7	

cent as compared to the private investment increase of 5.4 per cent a year.[1] The ratio of public investment to total investment, as a result, increased from 29.6 per cent during 1950-51 to 54.1 per cent during 1957-58. During the same period total investment as a percentage of national income increased from 6.6 during 1950-51 to 10 during 1956-57. It may also be noted that, according to a preliminary estimate by the Reserve Bank, during 1958-59 investment formed about 10.7 per cent of the national income.

Economic development can be measured not only in monetary terms but in physical terms as well. In this connection improvements in the agricultural production and the industrial production may be noted.

During the period 1950-51 to 1959-60 the index number of agricultural production in India increased from 93.7 to 124.7, the increase over the nine-year period ending March, 1960, being 33.1 per cent, as revealed in Table 34. Both foodgrains and non-foodgrains shared this increase, the respective increases being 37.3 per cent and 25. 7 per cent. However, variations in the agricultural production from year to year were considerable.

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[1] Bhatt, op. cit., p. 325.

TABLE 34

INDEX NUMBER OF AGRICULTURAL PRODUCTION IN INDIA DURING THE PERIOD 1950-51 TO 1959-60

(1952-53 = 100)

Groups/Commodities	Weights	1950-51	1951-52	1952-53
Foodgrains	66.9	89.5	90.1	100.0
(i) Cereals	58.3	89.0	89.9	100.0
(ii) Pulses	8.6	92.8	91.4	100.0
Non-foodgrains	33.1	102.0	106.5	100.0
All commodities	100.0	93.7	95.6	100.0

Source: *Reserve Bank of India Bulletin* (October, 1960), p. 1499.

TABLE 34 -- Continued

1953-54	1954-55	1955-56	1956-57	1957-58	1958-59	1959-60
117.8	113.7	114.0	119.5	106.7	128.7	122.9
118.4	112.9	113.3	118.8	107.0	127.5	123.5
113.4	119.9	119.8	124.4	105.5	136.8	118.6
100.9	116.5	115.5	125.8	123.4	131.7	128.2
112.1	114.7	114.5	121.6	112.4	129.7	124.7

Appreciable increases were also recorded in the area of industrial production. Among the more notable features of industrial development during the decade under observation was the progress in basic capital and producer goods industries, especially machinery and engineering industries. With the completion of three new steel plants in the public sector the total finished steel capacity created would increase to 4.5 million tons as compared to 1 million tons at the beginning of the First Plan, and 1.3 million tons at the beginning of the Second Plan. There was also recorded considerable increase in the production of essential industrial materials like cement, coal, aluminium, and so on. The growth in certain areas of industrial production during the period 1951-60 is shown in Table 35.

To conclude, the progress made in India during the ten-year period 1950-51 to 1959-60 was appreciable. An examination of such indicators as capital formation, national income, savings and investment, agricultural and industrial production revealed that an all-round development took place over the decade under study and the country was at a much higher level of economic activity in March, 1960, than in the beginning of April, 1950.

TABLE 35

INDEX NUMBER OF INDUSTRIAL PRODUCTION IN INDIA DURING THE PERIOD 1950 TO 1960

(1951 = 100)

Groups	1950	1951	1952	1953
Iron and steel	. .	100	102.2	95.7
Cotton textiles[a]	. .	100	103.7	107.1
All commodities	73.9[b]	100	103.6	105.6

Source: Reserve Bank of India, Report on Currency and Finance, 1955-56 and 1960-61; International Monetary Fund, International Financial Statistics, February, 1961, p. 158.

[a] Up to 1954, includes jute textiles.

[b] Converted from 1953 base to 1951 base.

TABLE 35 -- Continued

1954	1955	1956	1957	1958	1959	1960
113.2	113.3	119.4	119.3	119.1	163.1	208.8
110.0	111.9	117.5	115.6	108.9	111.5	115.4
112.9	122.4	132.6	137.3	139.7	151.1	170.3

The progress throughout the above period was, however, not uniform. During the First Plan period, for instance, the national income (in real terms) increased by 18.4 per cent and the per capita income rose by 11.1 per cent. The rate of investment as a percentage to national income increased from 6.0 per cent in 1951-52 to 9.3 per cent in 1955-56. The agricultural and the industrial production also followed the upward trend, increasing by 22.2 per cent and 79.4 per cent, respectively. On the whole the economic situation in India on the eve of the Second Plan (1955-56) was distinctly better than it was on the eve of the First Plan (1950-51).

During the Second Plan, it may be noted, the economic gains were not as appreciable as those recorded during the First Plan. During the first four years of the Second Plan (1955-56 to 1959-60) the national income (at constant prices) increased by only 12.2 per cent, while the per capita income went up barely by 6.6 per cent. Statistics on investment and savings for the year 1959-60 were not available. However, the Reserve Bank estimated that during 1958-59 savings formed about 7.7 per cent of the national income, while investment as a percentage of national income was about 10.7 per cent during the same year.

In terms of actual production agricultural production rose by 8.9 per cent during the period 1955-56 to 1959, whereas the increase in the industrial production over the period 1955 to 1960 was 39.1 per cent. These improvements in the economic indicators only reiterated the point that in real terms the First Plan was more successful than the first four years of the Second Plan.

CHAPTER V

MONETARY MANAGEMENT IN INDIA:
1950-51 TO 1959-60

The techniques of monetary policy in the contemporary world are undergoing a rapid transformation. Formerly the exclusive objective of monetary policy was to control the total supply of credit by varying the rates of interest at which the central bank was willing to discount bills, and to grant other kinds of credit. During the Great Depression in the 'thirties, which no doubt called for unorthodox remedies, monetary orthodoxy was progressively abandoned and even became to some extent discredited.

In recent years monetary policy has been coming more and more into its own as the promotion of economic growth is developing as an objective of credit policy. Central banks are concerned today not only with the control of the total volume of credit but also with the flow of credit into specific sectors of the economy. In India, for instance, the government of India stated:

> Central banking policy in a planned economy can hardly be confined to the regulation of overall supply of credit or to a somewhat negative regulation of the flow of bank credit. It would have to take on a direct and active role, firstly in creating or helping to create the machinery needed for financing development activities all over the country and secondly, in ensuring that *finance flows in the direction needed.*[1] (Italics supplied.)

With this objective in view the central bank applies constantly changing combinations of instruments among which an important role is played not only by variations of the rate of interest, but also by changing reserve requirements and by engaging in open market operations. Of comparatively recent development is the instrument of selective credit controls. This instrument is specially designed to influence specific sectors of the economy which are most vulnerable to fluctuations and need to be controlled without affecting the entire economy. In short, the methods of credit control applied by central banks today are adjusted to constantly changing situations.

The present chapter is divided into three parts: (1) an examination of the instruments available to the

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[1] Government of India, *First Five Year Plan*, p. 36.

Reserve Bank for monetary management, (2) a historical perspective of the instruments of monetary control used by the Reserve Bank during 1950-51 to 1959-60, and (3) an overall view of the history of monetary management in India.

General Credit Control

The statutory basis for the regulation of the credit system by the Reserve Bank is embodied in the Reserve Bank of India Act, 1935, and the Banking Companies Act, 1949. The former Act confers on the Bank the usual powers available to central banks generally, while the latter provides special powers of direct regulation of the operations of commercial banks.

Bank rate

The Reserve Bank of India defines its rate as the "standard rate at which it is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase."[1] The Bank also defines the kinds of papers acceptable to it for rediscounting,[1] with the necessary qualification that the bills eligible for rediscounting must be time bills. In case an instrument, otherwise acceptable to the Bank, is payable on demand, however, it must be duly converted into a time (usance) bill/note to become eligible.

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[1] Reserve Bank of India Act, 1934 (as amended up to March, 1960), Section 49, p. 25.

In practice, owing to the lack of a developed bill market in India, rediscounting of bills or promissory notes has been done by the Bank only on an insignificant scale.[1] Instead the Reserve Bank has extended loans and advances repayable on demand or for a maximum period of ninety days to scheduled banks, state cooperative banks, and certain public authorities against certain specified securities, which need not be time bills.[2] These advances are meant for the purpose of financing short-term (seasonal) trade transactions. In addition to the above facilities extended by the Bank it has the authority, on special occasions, to make short-term loans against any other type of security it considers sufficient.[3]

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[1] These provisions are related to Section 17 of the Reserve Bank of India Act, and are given below:

Section 17: The Bank shall be authorized to carry on and transact the several kinds of business . . . , namely,

2 (a): the purchase, sale and rediscount of bills of exchange and promissory notes, drawn on and payable in India and arising out of bonafide commercial or trade transactions bearing two or more good signatures, one of which will be that of a scheduled bank or a state cooperative bank, and maturing within ninety days from the date of such purchase or rediscount, exclusive of days of grace;

2 (b): the purchase, sale and rediscount of bills of exchange and promissory notes drawn and payable in India and bearing two or more good signatures, one of which will be that of a scheduled bank or a state cooperative bank and drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops, and maturing within fifteen months from the date of such purchase or rediscount, exclusive of days of grace: . . .

2 (c): the purchase, sale and rediscount of bills of exchange and promissory notes drawn and payable in India and bearing the signature of a scheduled bank and issued or drawn for the purpose of holding or trading in securities of the Central Government, or a State Government, and maturing within ninety days from the date of such purchase or rediscount, exclusive of days of grace.

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[1] Attempts to develop a Bill Market in India have been discussed in detail in chapter III.

[2] These advances are authorized under Section 17 (4) of the Reserve Bank of India Act. The Act also mentions the types of collateral which are acceptable to the Bank.

[3] This power is granted to the Reserve Bank under Section 18 (1) (3), which reads thus:

> When, in the opinion of the Bank, a special occasion has arisen making it necessary or expedient that action should be taken for the purpose of regulating credit in the interests of Indian trade, commerce, industry and agriculture, the Bank may make loans or advances repayable on demand or on the expiry of fixed periods not exceeding ninety days against . . . such other form of security as the Bank may consider sufficient.

Open market operations

The Reserve Bank is authorized to conduct open market operations in the traditional manner to influence the supply of credit in the market.[1] The law does not put any restrictions as to either the quantity or the maturity of securities in which the Bank can deal. The Reserve Bank Act authorizes the Bank to engage in the purchase and sale of securities of the central government or a state government of any maturity or of such securities of a local authority as may be specified in this behalf by the central government on the recommendation of the Bank. For this purpose securities fully guaranteed as to principal and interest by any such government or authority are considered to be securities of such government or authority. The Bank is empowered to purchase and sell short-term commercial bills. However, in the absence of a proper bill market little use has been made of this privilege. It may be noted that the Bank has no power to engage in the purchase and sale of stocks of corporations, with the exception of the stocks of the State Bank or any other bank or financial institution notified by the central government. Moreover, although there are no legal restrictions the dealings of the Reserve Bank in regard to open market operations are primarily confined to institutional investors, notably banks and, next in importance, life insurance companies.

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[1] Under Section 17(8) and (8A) of the Reserve Bank of India Act, open market operations of the Reserve Bank should take the form of:

> (1) purchase and sale of guaranteed securities of the central government or a state government of any maturity or of certain specified securities of a local authority, and (2) purchase and sale of shares in, or the capital of, the State Bank of India or of any other bank or financial institution notified by the central government in this behalf.

Variable reserve requirements

The Reserve Bank had no statutory authority to vary reserve requirements of banks until 1956 when the Reserve Bank Amendment Act empowered it to vary the required reserves of scheduled banks between 5 per cent and 20 per cent in respect of demand liabilities and between 2 per cent and 8 per cent of time liabilities.[1] The Bank was also empowered, in case of need, to require scheduled banks to maintain with it additional cash reserves computed with reference to the excess of demand and time liabilities over the level of such liabilities on a base date to be selected by the Bank. This provision was, however, subject to the condition that the total reserves to be maintained with the Bank by the scheduled bank would not exceed 20 per cent of its demand and 8 per cent of time liabilities.

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[1] All banks (both scheduled and non-scheduled) are required to maintain a reserve of at least 2 per cent of time and 5 per cent of demand liabilities. Scheduled banks must maintain such reserves with the Reserve Bank, whereas it is optional for the non-scheduled banks to maintain the reserves either with themselves, or with the Bank, or at both places.

Selective and direct credit controls

The Reserve Bank of India is also authorized, in addition to general controls, to resort to selective credit controls. The basis of selective controls is that, consistent with a general credit situation appropriate to a healthy economic system, credit may be so easy to obtain for some purposes that demand expands unduly in particular directions, or speculative activities are over-excited, endangering the stability of the whole economy. A general control measure in such circumstances might seem undesirable; yet something in the form of selective controls must be done in order to control excessive credit demands in particular directions. A further need of selective credit control is its use as a supplement to general control when the latter cannot be expected to act in a specific sector either quickly or strongly enough to deal with an inflationary situation. It may be pointed out here that in the context of India's planned development the technique of applying selective controls is very important, since there often arises the need to direct the flow of credit to desirable channels without making the monetary policy restrictive.

The Banking Companies Act of 1949 confers on the Reserve Bank the power to regulate advances by all banks. The Bank has also the power to give directions to banks in regard to their advances policies. Finally the Act empowers the Bank to resort to direct controls. For instance, the Reserve Bank may advise and prevent any bank or a group of banks from carrying on certain types of business which are considered detrimental to the interests of the economy.

Moral suasion

In the wider sense of the term moral suasion may be treated as one of the milder forms of selective credit control with the important difference that this instrument is not accompanied by statutory or administrative compulsion or threats of punitive action. Consequently, moral suasion carries with it the advantage of creating a less unfavorable psychological reaction and a greater response to the appeal of the authorities. In India scheduled banks, and more specifically, a handful of the larger scheduled banks, control most of the banking business. These banks have elaborate administrative machinery and are controlled by highly trained personnel who are able to envision the role of banks in the important task of nation building. Hence it is comparatively easier for the monetary authorities at least occasionally to convince these few banks of the necessity of controlling bank advances in the most desirable manner.

History of Monetary Policy in India

In November, 1951, the monetary policy took a radical turn. The Reserve Bank rate was raised, for the first time since 1935, from 3 to 3.5 per cent. Simultaneously, "with a view to making the Bank rate effective,"[1] a fundamental change was made in the open market policy. In pursuance of the Bank's earlier policy of maintaining interest rates on government loans at the level established during and after World War II, it was the normal practice of the Bank to buy government securities offered to it for sale at the market rates. Scheduled banks were, therefore, able to provide themselves with funds during the busy season by selling to the Bank government securities in their portfolio. As a result of this practice the market was in a position to augment the money supply freely even in the midst of inflationary pressures.

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[1] Reserve Bank of India, Report of the Central Board of Directors for the Year Ending June, 1952, p. 13.

Under the new policy the Bank announced that during the busy season of 1951-52 it would, save in exceptional circumstances, refrain from buying government securities to meet the seasonal requirements of scheduled banks; but would, as a normal practice, advance money at the prevailing Bank rate on government and other securities specified in the Reserve Bank of India Act. This change in the open market policy, coming as it did at the advent of the busy season, was specially designed to make the monetary policy immediately effective in controlling the expansion of bank credit.

Following the change in the Bank rate and the open market policy, the Reserve Bank introduced in January, 1952, the Bill Market Scheme,[1] under which advances were to be granted to scheduled banks having deposits of not less than Rs. 100 million on the security of usance promissory notes of their constituents. This Scheme aimed at adding considerable flexibility to the operations of the Bank as lender of the last resort. It was also felt that the Scheme would help the Bank to ensure that such advances were for bona fide trade purposes and for short periods.[1]

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[1] The Bill Market Scheme has been discussed in detail in chapter III.

A major shift in the monetary policy was next recorded in 1956. In that year, keeping in view the changed requirements of monetary and credit policies in the context of the starting of the Second Five Year Plan,[2] the Reserve Bank of India (Amendment) Act was passed. The Act established a system of flexible reserve ratio for the first time, giving the Bank the power to vary the required reserves which scheduled banks were required to maintain with it between 5 and 20 per cent in the case of demand liabilities, and between 2 and 8 per cent in the case of time liabilities.[3] The Act also amended the currency reserve provision. It provided for a minimum holding of Rs. 4,000 million in foreign securities and of Rs. 1,150 million in gold in the Bank. This was in modification of the earlier provision which required that not less than 40 per cent of the assets of the Issue Department of the Bank must consist of gold coin, gold bullion, or foreign securities provided that the amount of gold coin and gold bullion was not at any time less than Rs. 400 million in value, gold being valued for this purpose at the rate of approximately Rs. 21 per _tola_ (that is, three-eighths of an ounce). The amending Act also provided for revaluing the gold holdings of the Bank at Rs. 62-8 per _tola_. Finally a provision was made in the Act to suspend temporarily the assets requirements in respect of foreign securities, provided that the amount of foreign securities held in the Issue Department did not any time fall below Rs. 3,000 million in value. In short this Act changed the _proportional_ reserve system for notes to a _fixed minimum system_. Consequently this Act paved the way for a smoother monetary expansion for financing the Second Five Year Plan.

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[1] To popularize the Scheme, restrictions were liberalized in subsequent years. See Reserve Bank of India, Report of the Central Board of Directors for the Years Ending June, 1952, through 1960.

[2] Financially speaking, the Second Plan was much more ambitious than the First Plan. See chapter IV for details.

[3] Prior to the amendment, the requirements were 2 per cent in regard to time and 5 per cent in respect of demand liabilities.

Besides institutional changes the year 1956 also witnessed modifications in the area of general controls. For instance, the new open market policy initiated in

November, 1951, by which the Bank had decided not to buy government securities save in exceptional circumstances was revised. The revised policy of the Reserve Bank was to lend "discriminating support"[1] to the market, which was consistent with the Bank's policy of controlled expansion in the development phase.

The year 1956 proved very significant in another respect. The Bank used selective controls for the first time on a systematic basis and on a significant scale.[2] As the Bank pointed out: ". . . credit policy was *mainly one of flexible selective control*, which, while meeting the genuine credit requirements of trade and industry, was directed against the use of credit for assisting speculative activity in certain commodities."[3] (Italics supplied.)

Until 1949 the policy of using selective credit controls as an instrument of credit policy was almost absent in India. As mentioned earlier, a provision was made under the Banking Companies Act, 1949, enabling the Reserve Bank to give directions to commercial banks either generally or to any one of them as to the purpose for which advances were to be made, the margins to be maintained, and the rates to be changed.[1] This provision placed immense powers in the hands of the Bank.

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[1] Reserve Bank of India, *Report of the Central Board of Directors for the Year Ending June, 1957*, p. 15.

[2] Statutory provisions regarding selective controls are discussed in Part I of this chapter.

[3] Reserve Bank of India, *Report of the Central Board of Directors for the Year Ending June, 1957, p. 15*.

It was not until the implementation of the Second Five Year Plan,[2] however, that the Bank made use of selective credit controls through directives to commercial banks on a systematic basis. The prescriptions of higher margins and the efforts at regulation of the aggregate level of advances against specific commodities constituted the distinguishing features of the technique of selective controls. The controls were used with flexibility and their imposition and withdrawal were dictated by the need to restrain speculative credit demands while meeting genuine credit requirements.[3]

On April 4, 1956, the Bank issued a circular to scheduled banks calling for fortnightly returns of advances in order to bring bank advances under close observation. A directive was again issued to the banks a month later asking them (1) to refrain from excessive lending against commodities in general, (2) not to grant fresh advances or credit limits to individual parties in excess of a specified limit, and (3) to raise the existing margins in respect of loans against paddy and rice by 10 per cent.

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[1] Reserve Bank of India Bulletin (April, 1949), p. 229.

[2] The Second Plan was inaugurated on April 1, 1956.

[3] See various issues of the Reserve Bank of India Bulletin.

With the decline in advances against paddy and rice, and with a view not to hamper the movement of the new crop, restrictions on paddy and rice were withdrawn on November 14, 1956, but were reimposed on February 9, 1957, as advances against these commodities increased considerably after the withdrawal of restrictions.[1] Earlier, in September, 1956, the Bank extended these controls to cover bank advances against wheat, other coarse grains, gram, pulses, and cotton textiles when similar tendencies to speculative withholding of stocks were observed.

In view of the rising trend of bank credit against foodgrains the Reserve Bank issued on June 7, 1957, a directive to all scheduled banks designed not only to curb bank finance for speculative holding of stock but also to bring down substantially the level of advances against these commodities.[1] A new directive in suppression of the earlier one was subsequently issued on December 11, 1957, with a view to restricting the seasonal expansion in bank advances against foodgrains.[2] Earlier, on June 29, 1957, the Bank had issued a directive to scheduled banks regarding advances against sugar. It was modified on July 15, 1957, and again on December 11, 1957.[3]

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[1] Reserve Bank of India Bulletin (February, 1947), p. 146.

In addition to general and selective credit controls, use was made of moral suasion, frequently as a "preparation ground" for selective controls. Another reason for resorting to moral suasion was that it was not accompanied, as mentioned earlier, by statutory compulsion, and hence carried with it the advantage of creating a less unfavorable psychological reaction and a greater response to the appeal of the authorities. Besides, it may be noted, the institutional setting in India made the instrument of moral suasion particularly suited for the country.

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[1] *Ibid.*, June, 1957, p. 562.

[2] *Ibid.*, July, 1957, p. 645; also December, 1957, p. 1212.

[3] *Ibid.*, December, 1957, p. 1212.

Moral suasion, in the form of requests to banks and conferences with the representatives of selected banks, was used by the Reserve Bank five times during 1957. In April, 1957, when the economy seemed to be threatened by the imminent dangers of inflation, the Bank, for the first time since 1949, requested the scheduled banks to desist from making advances against shares to parties seeking to acquire a controlling interest in commercial enterprises by cornering shares (stocks). Barely a couple of months later in June, 1957, in a letter the Bank drew the attention of scheduled banks to certain aspects of the prevailing economic situation arising from the large-scale expansion of bank credit; and the cooperation of these banks was sought in achieving a positive reduction in the level of bank credit without diminishing assistance to the essential sectors of the economy. The banks were also asked to take steps "to reduce their systematic and continued reliance on the Reserve Bank, as a situation might arise calling for a review of the present arrangements regarding assistance from the Reserve Bank."[1] The letter was interpreted as a shift from a policy of "cautious lending" to one of "positive and constructive restraint." The need for caution and reduction in the total bank credit was again reiterated by the Bank in its meetings with bankers in July and August when it urged the banks as a whole to bring down their advances to a specified lower level by the middle of October, 1957.

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[1] See Reserve Bank of India, Report of the Central Board of Directors for the Year Ending June, 1957, p. 16.

The Reserve Bank once again met the representatives of selected banks in November, 1957, to emphasize to them the need for vigilance in their lending operations. It was also indicated that the Bank would grant accommodation under the Bill Market Scheme with more restraint and greater selectivity.

While moral suasion and selective controls continued to play a very important role, during the first half of 1957 these controls were reinforced by the application of a measure of general control through a rise in the Bank's lending rates.[1] Early in 1956 the Bank's lending rate against usance bills was raised from 3 to 3.25 per cent; subsequently in November this rate was further raised to 3.5 per cent. Another important development occurred in February, 1957, when, due to an increase by the Bank of the stamp duty on usance bills, the effective cost of borrowing under the Bill Market Scheme was raised from 3.5 to 4 per cent. Simultaneously the Bank raised its lending rate against government and other approved securities. Finally, in May, 1957, the Bank also raised its rate from 3.5 to 4 per cent, mainly by way of realignment with the trend in the money market rates and also to make the structure of lending rates of the Bank internally more consistent.[1]

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[1] Ibid., p. 15.

In addition to important changes in monetary policy a need was also felt in 1957 to amend the Reserve Bank Act on account of the continuous drain on the country's gold reserve. The Reserve Bank of India (Second Amendment) Act, 1957, consequently provided that the aggregate value of gold coin, gold bullion, and foreign securities held in the Issue Department of the Bank should not at any time be less than Rs. 2,000 million, of which the value of gold coin and gold bullion should not be less than Rs. 1,150 million. This amendment was in line with the general trend of central banking legislation in recent times in India to unlink foreign reserves from the note issue.

The Reserve Bank continued to put major reliance on selective controls during 1958. Consequent on the disproportionate rise in bank advances against sugar during the first half of 1958 the minimum margin for bank advances against this commodity was raised in July from 35 to 45 per cent. In September a new directive was issued in terms of which the average level of advances from October, 1958, against wheat were required to be maintained at a specified level.

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[1] *Ibid.*

The restrictive policy was carried through the month of December when the Bank issued another directive which, while continuing generally the existing structure of control on advances against all foodgrains, made a change in the method of calculating the ceiling limits on advances against them.

Selective controls were also extended in 1958 to cover bank credit on the stock exchange. Bank advances against shares and debentures were steadily rising along with the rise of bank advances against sugar during the first half of the year. The Bank therefore issued a directive in August guiding banks to be cautious in the matter of advances against shares.

In 1959 selective controls were again imposed vigorously along with moral suasion, the latter being resumed after a year. During the year the area of selective controls was partially expanded, covering such commodities as groundnuts, oilseeds, and foodgrains. In two of these cases controls were made more restrictive, while in the remaining case ceiling limits of advances against foodgrains were liberalized to meet with the changed situation.

In the same year, or more specifically, in February, 1959, moral suasion was revived when the Bank asked scheduled banks to use restraint in granting advances, particularly clean advances, and also requested them to limit their access to the Bank. This request was later followed in June by a circular letter calling upon the banks to effect during the 1959 slack season a significant reduction in advances of at least about Rs. 1,000 million. Furthermore, on December 11, 1959, "with a view to making selective controls more effective,"[1] and also to minimize the circumvention in the form of clean advances, the Reserve Bank requested the scheduled banks to discourage the practice of discounting clean _hundis_ drawn by parties affected by selective credit controls.

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[1] Reserve Bank of India, _Trend and Progress of Banking in India_ (Bombay: Reserve Bank of India, 1959), p. 9.

During the first quarter of 1960 (March 11, 1960), in order to meet the situation arising from the marked expansion in money supply and bank credit and their impact on the stock and commodity markets as well as on the general price level, the Reserve Bank announced a series of further credit restraint measures. These measures consisted not only of selective credit controls but also included, for the first time, resort to the instrument of variable reserve requirements. The selective credit control measures consisted of: (1) the imposition of a minimum margin of 50 per cent in respect of advances by scheduled banks against ordinary shares, above an amount of Rs. 5,000, (2) a ban on direct financing of budla (switch) transactions by scheduled banks through purchase of shares in their name for the current settlement and sale for the next settlement; and (3) fixation of a ceiling on clean (that is, unsecured) advances.[1]

On the same day the Reserve Bank impounded 25 per cent of the additional deposits flowing into the banking system after March 11, 1960. It might be of some interest to note in this connection that while scheduled banks could be legally called upon to maintain reserves with the

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[1] Reserve Bank of India, Report of the Central Board of Directors for the Year Ending June, 1960, pp. 15-16.

Reserve Bank up to a maximum of 20 per cent of demand and 8 per cent of time liabilities the Bank did not make any such distinction in resorting to this measure, nor did it relate the percentage to total deposits. Instead it made the higher margin applicable at a uniform rate to all classes of deposits that would accrue after the date of the order. This method was followed presumably to accord a fair treatment to all types of banks and also to avoid penalizing those banks which had taken more pains to attract deposits.[1]

Overall View

An overall view of the general and selective instruments of credit control that were used during the ten-year period ending March, 1960, reveals that whereas both these types of instruments were used as complementary to each other, since 1956 selective controls were used much more frequently than general controls. In fact, since May, 1956, each of the two general credit control instruments, namely, the Bank rate and reserve requirements, was used but once, but selective controls were used nineteen times. These controls were primarily directed towards foodgrains, but were also extended to sugar, groundnuts, other oilseeds, cotton textiles, and stocks and shares.

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[1] "Controls on Bank Credit," *Commerce*, March 1, 1960, p. 450.

That the monetary authorities preferred in many instances selective controls to the instruments of general control was clearly revealed by the statement made by the Reserve Bank. It said: "The role of selective credit controls in their impact on prices might be regarded as of marginal significance in Indian conditions . . ."[1]

The official preference for selective controls is based on the following arguments. In the process of India's economic development there is a legitimate and essential need for higher bank credit to be channeled into desirable avenues which in turn would encourage investment. Selective controls are designed to restrain particular types of investment or consumption. What is more important regarding these controls, however, is the fact that they serve to divert the flow of bank credit into the channels most desirable from the point of view of the economic development of India. Moreover, the operation of selective controls can be discriminatory not only in regard to advances against different articles but also within the field where the controls are being imposed. It is true that selective controls are highly discriminatory. The official answer to that objection is that all types of controls are likely to prove discriminatory in some respects. Besides, in India there has already been set a preference for a socialistic economy in which the government plays a major role in the development process, and hence selective controls would seem to be compatible with the present economic set-up in India.

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[1] Reserve Bank of India, Trend and Progress of Banking in India, 1959, p. 10.

CHAPTER VI

MONETARY POLICY AND ECONOMIC DEVELOPMENT: A THEORETICAL MODEL

It is the overwhelming consensus of economists that monetary policy is essential to any program for achieving economic development. More specifically, in almost all underdeveloped countries there is a universal concern with the problem of how to use monetary policy to stimulate economic development. That is to say almost every growing nation is confronted with the dilemma of how to achieve the stimulating effects of an expanding money supply without suffering the disruptive consequences of inflation.

The aim of this chapter is to evaluate, on a theoretical basis, the role of monetary policy in a growing economy which primarily concerns itself with the problem of accelerated economic development. In chapters VII and VIII an attempt will be made to evaluate critically, in terms of the theoretical model built in this chapter the role of monetary policy in India during the ten years of planning.

Since this study is concerned with the study of inflation vis-a-vis economic development it is desirable to state precisely the concept of inflation. By inflation "most people understand a substantial and rapid rise of the general level of prices."[1] Inflation is normally associated with high prices, because it is the rapidly shrinking value of the monetary unit that is easily recognizable. Einzig goes a step further and makes a distinction between money inflation and price inflation. The first relates to that stage of inflation in which overexpansion of money beyond the normal requirements for it pushes up prices; the second relates to the succeeding stage, in which prices get out of control and rise so rapidly that money supply lags behind. And he defines inflations "as a state of disequilibrium in which an expansion of purchasing power tends to cause, or is the effect of, an increase of the price level."[2] This interpretation brings within the scope of the term inflation not only that familiar phenomenon of too much money chasing too few goods but also the other and the more vicious aspect of the problem of a wage, cost of production, and price spiral, in which each becomes at the same time the cause and the effect.[1]

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[1] Arthur J. Brown, Applied Economics: Aspects of the World Economy in War and Peace (London: G. Allen and Unwin, 1947), p. 92.

[2] Paul Einzig, Inflation (London: Chatto and Windus, 1952), p. 22.

Inflation in an underdeveloped economy generally occurs in a situation in which there is an abnormal increase in the effective demand exerted mainly by the government as in a process of economic development. Financing the economic development either by taxation or borrowing, or by an expansion of the money supply, involves the restriction of consumption by the community and the increased use of the nation's resources by government for stepping up the rate of investment by making "forced savings." Such savings are enforced on the people either by means of taxation or by means of an increasing money supply.

Expansion of the money supply, resulting in increased effective demand by the State, works itself out into an inflationary pressure in two ways.[2] First, to the extent that higher prices are offered by the government in competitive buying the effect on the general price level is direct. Second, the supply of resources available for private consumption is lessened since a portion of these resources is channeled into government-approved projects (usually long-term capital projects). This reduction in consumption goods without a corresponding decrease in the money supply also exerts an upward pressure on the price level.

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[1] D. Bright Singh, _Inflationary Price Trends in India since 1939_ (Bombay: Asia Publishing House, 1957), p. 10.

[2] _Ibid._, p. 10.

Essentially, inflation develops because of the lag between effective demand and output. However, increased utilization of resources by the State need not always be at the expense of consumption goods or resources available for the community. For, so long as there are unutilized resources existing in the economy such idle resources can be drawn into the economy without the curtailment of consumption. This means that when full utilization of any factor of production is reached further increase in its demand can manifest itself only in the form of a higher price level.

It is important at this stage to distinguish between what we call "money inflation" and what Keynes termed "true inflation." As is well known, it is the _full-employment_ inelasticity of output relative to rising effective demand that serves as the criterion of "true inflation" in the Keynesian sense, though Keynes grants the possibility of some inflation even before the full-employment level arising from specific bottlenecks.[1] In underdeveloped economies, however, "true inflation" is to be found in the inelastic full-capacity output.[2] For in those economies the lack of real capital, and not of labor, is the ultimate bottleneck to "real" expansion relative to "monetary" expansion.

Having observed the character of "true inflation" in underdeveloped countries, a distinction may now be established between "money inflation" (or monetary expansion) and "true inflation" in these economies. So long as an expansion in the money supply can bring idle resources into use, granting some time lag, the inflation generated in the economy is to be identified with "money inflation."

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[1] John M. Keynes, The General Theory of Employment, Interest and Money (New York: Harcourt, Brace and Company, 1936), pp. 296-302. Note specifically: "If we assume a sufficient interval for the quantity of equipment itself to change, the elasticities of supply will be decidedly greater eventually. Thus a moderate change in effective demand, coming on a situation where there is widespread unemployment, may spend itself very little in raising prices and mainly in increasing employment; whilst a larger change, which, being unforeseen, causes some temporary 'bottlenecks' to be reached, will spend itself in raising prices, as distinct from employment, to a greater extent at first than subsequently." Ibid., pp. 300-301.

[2] Kenneth K. Kurihara, The Keynesian Theory of Economic Development (New York: Columbia University Press, 1959), p. 145.

However, if the "inflationary financing" of investment has only an "income generating" effect rather than a "capacity increasing effect,"[1] such an inflation may be called "true inflation,"[2] in an underdeveloped country.

The problem of the measurement of inflation may now be discussed. Inflation is not susceptible to measurement by any single criterion or economic indicator. Hence there is a need for a number of indicators of different kinds and degrees of importance. The increase in the price level is generally a major clue to inflation, although certain limitations are attached to this indicator. No single index published in India, for instance, is entirely satisfactory as a current measure of general price movements. Some indices are not comprehensive enough; others are available only at intervals longer than desired. In all cases, changes in the quality of the items covered and in the composition of the "market basket" present difficult technical problems.

The two price indices that are most widely known in India are the wholesale price index and the consumer price index. The former shows price movements at relatively early stages of the production-distribution process. It is, therefore, a good indicator of impending movements of finished goods priced at the retail level. However, the wholesale price index does not contain prices for most of the services purchased by consumers. Besides, there are about ten items included in the index of wholesale prices computed by the Office of the Economic Adviser to the government of India on which there are statutory controls and the prices quoted are those of the fair price shops or the control rates. The total weight of these commodities is estimated to be about 11 per cent in the general index. If free market prices of these commodities were included the index would undoubtedly be higher.

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[1] Ibid.

[2] It needs to be recognized that, although theoretically money inflation can be distinguished from true inflation, it is extremely difficult to measure the extent of money inflation as opposed to true inflation in an economy.

For this reason the consumer price index, which measures changes in the price of goods and services bought by average families, can be treated as an effective indicator for measuring inflation. In the initial stages of development through which India is passing even this index is not very satisfactory. The reason is clear. Of necessity, investment of the public sector is channeled into basic and heavy industries producing capital goods. As additional income is generated by considerable development expenditure which does not directly produce consumer goods, such as expenditure on the great river projects, power schemes, and the steel plants, a two-way pressure is exerted on the prices of consumer goods. The supply of these goods is restricted on the one hand, and on the other the demand for these goods is intensified because of the generation of the additional income. This type of money inflation must be treated as an ineluctable concomitant of the development process and not "true inflation."

Expansion in the total money supply (coin, currency with the public, and demand deposits with banks) is another indicator for measuring inflation. There are two schools of thought on the desirability of using this indicator for measuring inflation. One school, known as Quantity Theorists, explains inflationary trends in prices in terms of an increase in the supply of money. Thus Irving Fisher, after examining the price trends in Europe and the USA in the nineteenth and earlier part of the twentieth century, concluded that the

> Price level almost invariably shifts with monetary factors -- gold, silver, paper, credit -- and very little with commodity factors. The latter control only the deviations of individual prices from the average price movement. In a word, supply and demand dictate each individual price relative

> to the price level, but money dictates the price level itself.[1]

It follows from the above thesis that an expansion of money followed by no commensurate expansion of the supply of goods and services should result in an inevitable rise in prices. In this sense "inflation occurs when the volume of money actively bidding for goods and services increases faster than the available supply, when the growth of national income in money units is greater than its growth in physical units."[2]

The other school, to which Wicksell, Bent Hansen, and Keynes belong, defines inflation as the situation in which the total demand for goods as shown by the volume of money offered is in excess of the supply of goods at prevailing prices. For instance, Bent Hansen expresses Wicksell's viewpoint on inflation in the following terms: "The general price-level [is] determined by the total demand for and total supply of the group of goods concerned, the prices of which determine the general price level."[3] In this analysis excess demand becomes the hallmark of inflation.

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[1] Irving Fisher, Inflation? (New York: Adelphi Company, 1933), p. 45.

[2] Emanuel A. Goldenweiser, "Inflation," Federal Reserve Bulletin, XXVII (April, 1941), 291.

[3] Bent Hansen, A Study in the Theory of Inflation (New York: Holt, Rinehart and Winston, 1951), p. 2.

The quantity theory of money, despite its limitations, holds good in a full-employment economy. As Keynes remarked: "When there is full employment, prices will change in the same proportion as the quantity of money."[1] This is because an increase in the quantity of money, insofar as it increases effective demand, fully spends itself on a proportionate increase in prices when output can no longer be expanded.[2] Of course, the effect of an increase in money supply on the price level is not always proportionate; since the velocity of money is more than likely to change with an expanding money supply. In the case of an underdeveloped country also this theory is relevant since the inelasticity of capital situation that exists in such a country is, in a broad sense, analogous to the full employment situation of a developed economy. Thus,

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[1] Keynes, op. cit., p. 296.

[2] Patinkin argues that two conditions are necessary to make the quantity theory valid: (1) full employment, and (2) absence of "money illusion." He says: "If the speculative demand were free of money illusion, -- i. e., if the amount of money demanded for speculative purposes were proportionate to the amount of money and the price level -- then it would no longer be true that the only way this demand could absorb part of the increase in the amount of money would be through a fall in the rate of interest. For, even at the same rate of interest, the rise in prices and amount of money would cause the amount of speculative demand to increase. Hence, the rate of interest need not change." See D. Patinkin, "Keynesian Economics and the Quantity Theory," in K. K. Kurihara (ed.), Post-Keynesian Economics (New Jersey: Rutgers University Press, 1954), p. 146.

> . . . if the money supply in the country . . . runs substantially ahead of the increase in the production of goods and services, the price level is bound to rise after an interval of time. If, on the contrary, money supply rises more slowly than the production of goods and services, the price level is likely . . . to fall.[1]

For the sake of convenience as well as appropriateness the present chapter is divided into four parts: (1) the role of government in the process of development, (2) a discussion of the role of the central bank in economic development, (3) a more detailed discussion of the restrictive and developmental roles of monetary policy, and (4) a discussion of the role of monetary policy in economic development.

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[1] H. V. R. Iengar, "Monetary Stability and the Role of the Reserve Bank," Reserve Bank of India Bulletin, XIV (November, 1960), 1608. (An address delivered before the Society for International Development at Madras, November 1, 1960.)

The Role of Government in Economic Development

It was observed in chapter II that, granting the limitations pertaining to private savings and government taxation, economic development can be accelerated only if the government takes the initiative in increasing the savings for the community. This is true in spite of the handicap of an inefficient administrative organization as well as an inadequate fiscal and monetary machinery from which many of these countries suffer. As a matter of fact some economists take the extremely conservative view that in underdeveloped nations there is a need for "countervailing power to initiate the process of development."[1] There are other economists who emphasize the almost exclusive reliance on government savings for economic development. For instance, Mrs. Hicks points out that

> . . . the part which private enterprise is likely to play in this [matter of economic development] is almost wholly small scale, and does not more than nibble at the problem . . . . Whatever the nature of industrial development it is seldom of a kind to attract private enterprise capital save in directly

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[1] H. Myint, "An Interpretation of Economic Backwardness," Oxford Economic Papers, VI (June, 1954), 163.

> owned small scale development. The bulk of the work of starting industries must therefore also be undertaken by governments.[1]

The views of the Indian Planning Commission in this regard are also illuminating. The Commission states:

> It is clear that in the transformation of the economy that is called for the state will have to play the crucial role. Whether one thinks of the problems of capital formation or of the introduction of new techniques, or of the extension of social services, or of the overall re-alignment of the productive forces and class relationships within the society, one comes inevitably to the conclusion that a rapid expansion of the economic and social responsibilities of the state will alone be capable of satisfying the legitimate expectations of the people.[2]

The views quoted above are suggestive of the fact that in underdeveloped economies fiscal policy of the government should be used as the main instrument for capital formation. The fiscal policy undertakes to do the following: (1) influence the overall demand in the economy, (2) reduce consumption of the people, (3) redistribute income of the people, (4) provide positive inducements for saving and investment, (5) undertake development projects, and (6) create public savings through deficit financing (borrowing from the banking system and/or the public).[1] This study will concern itself with the monetary implications of deficit financing. It may be noted, however, that as mentioned earlier there is only a very limited scope for borrowing from the public in underdeveloped countries. Hence the role of "bank financing" in the economic development of these countries will be given special importance in the discussion that follows.

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[1] Ursula K. Hicks, "The Search for Revenue in Underdeveloped Countries," Revue de Science et de Legislation Financieres, XLIV, No. 1 (Jan.-March, 1952), 20.

[2] Government of India, First Five Year Plan, p. 32.

It is important to point out here that there is no consensus in regard to the concept of "deficit financing." The phrase "deficit financing" has been used in the West to "describe the financing of a deliberately created gap between public revenue and public expenditure or a budgetary deficit, the method of financing resorted to being borrowing of a type that results in a net addition to national outlay or aggregate expenditure."[2] In contrast to the above, the Indian Planning Commission has accepted a modified concept of deficit financing. According to the Commission:

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[1] Divakar Jha, "Fiscal Policy and the Economic Development of Underdeveloped Countries," Indian Journal of Economics, XXXVII (July, 1956), 95.

[2] V. K. R. V. Rao, "Deficit Financing, Capital Formation, and Price Behaviour in an Underdeveloped Economy," Eastern Economist Pamphlets, 1953, p. 1.

> The term deficit financing is used to denote the direct addition to gross national expenditure through budget deficits whether the deficits are on revenue or on capital account. The essence of such a policy lies therefore in Government spending in excess of the revenue it receives in the shape of taxes, earning of State enterprises, loans from the public, deposits and funds and other miscellaneous sources. The Government may cover the deficit either by running down its accumulated balances or by borrowing from the banking system (mainly from the Central Bank of the country and thus "creating" money).[1]

The significance of this modified concept of deficit financing accepted by the government of India is that borrowing from the public is not considered a part of deficit financing. The reason for excluding borrowing from the public is as follows. When the government borrows from the public, it is argued, it takes away a part of their purchasing power. Government spending to the extent of its borrowing from the public therefore does not result in a net addition to the aggregate expenditure and should be excluded from the concept of deficit financing.

The above argument is imperfect because it fails to recognize that the "total leverage effect" of government expenditure out of the funds borrowed from the public may be, and frequently is, larger than the funds left in private hands. Since this is a significant difference, the modified concept of deficit financing that is proposed to be used in later discussions will be called the concept of "Indian deficit financing."

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[1] Government of India, First Five Year Plan, p. 59.

Whether one takes the Western view or the Indian view of deficit financing, the fact remains that the technique of deficit financing is applied as a device for diverting resources from current consumption to capital formation which largely consists of the creation of currency or credit. An important conclusion that might be drawn from this is that developmental deficit financing can operate only _internally_ and not _externally_. This point requires further elucidation. An essential part of developmental financing consists of the large importation of capital goods. A country cannot secure capital goods (or for that matter any type of goods) from abroad directly through the medium of deficit financing. Internally created currency or credit is useless _qua_ money for other countries. For importing capital goods external resources are essential which can be secured either in exchange for surplus domestic produce or through foreign borrowing, the scope of the latter being severely limited in terms of the total needs of the underdeveloped countries. It is now possible to see how important it is for the underdeveloped countries to accumulate external resources (or foreign exchange reserves) in order to import capital goods in excess of their current capacity. It also follows that the rate of capital importation (and therefore the developmental planning itself) is primarily dependent not so much on the current favorable balance of trade but rather on the availability of foreign exchange reserves in the country.

The monetary implications of deficit financing may now be examined. It has been mentioned above that the government of an underdeveloped country resorts to this type of financing primarily to divert resources from the current consumption to capital formation. The immediate result of deficit financing is to create additional currency or credit. This additional purchasing power enables the government to outbid consumers in the procurement of resources and use them for capital formation. As a result the money supply rises, which is associated (perhaps with a time lag) with a decline in the availability of consumer goods. The combined effect of these is frequently the generation of inflation in the economy.

What has been said above does not necessarily suggest that deficit financing for capital formation is always inflationary. In fact to a certain degree the expansionary character of deficit financing does fulfill the currency and credit needs of a developing economy. As an underdeveloped country attains higher stages of development, its productive capacity increases. In consequence the supply of goods and services gradually expands and a greater demand is felt for cash balances by the public and working funds by the producers and businessmen. As trade and commercial activity gathers momentum more ready cash is needed to finance individual and corporate transactions. Furthermore, with the development of modern means of transportation and the enlargement of trade the traditional isolation of the rural economy -- where a large percentage of the total transaction does not involve the use of money -- gradually breaks down and money comes into greater use. As a natural corollary to this development process, a substantial portion of the saving[1] is done in the form of money. Consequently there arises a definite trend towards a greater demand for financial assets and the enlargement of money and capital markets. In summary, all of these factors create a demand for additional currency and credit.

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[1] Savings refers to money saving.

It would appear from the above analysis that a larger quantity of money supply is not only desirable but also a concomitant of a higher level of economic activity. Even though an increase in the money supply may not be accompanied by a corresponding increase in production a larger volume of money supply is consistent with rapid economic development. This is because a certain degree of inflation (that is, money inflation) is inherent in the very process of development.[1]

The above view can be substantiated by the experiences of many nations which realized rapid economic growth, like the United States of America, where the rate of money expansion during the periods of rapid advance had been faster than the rate of growth of output. For the United States, Alvin Hansen writes:

> Looking at the whole 150 years, it is important not to lose sight of the generalization already made that the spectacular rise in the national income has been accompanied by a far more rapid

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[1] Dattarao R. Khatkhate, "Impact of Inflation on India's Economic Development," Economic Development and Cultural Change, VII, No. 3, Part 1 (April, 1959), 363.

> increase in the money supply. Indeed, the money supply in 1947 was 60 per cent larger (relative to income) than in 1900, and 120 per cent larger than in 1880; eight times as large (relative to income) than in 1900, and 120 per cent larger than in 1880; eight times as large (relative to income) as in 1820, and sixteen times as large as in 1800. Evidently as the nation has grown in wealth and widened the market economy, the amount of money which people wished to hold, in relation to income, has grown decade by decade.[1]

Similar facts for Great Britain have been presented by A. E. Fearveryear in his book entitled The Pound Sterling.[2] And "the same holds true for Germany, Japan, the USSR, etc., for the hectic decades of their rapid economic growth."[1] Such pragmatic studies have not been made in underdeveloped countries. Nevertheless, in the current literature there are two sets of strong arguments in support of monetary expansion for financing developmental and growth activities in these countries.

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[1] Alvin H. Hansen, Monetary Theory and Fiscal Policy (New York: McGraw-Hill Book Company, 1949), p. 6.

It should be noted, however, that there are economists who maintain that the periods of greatest economic development in the US have coincided with periods of less selective expansion in prices. For instance, King maintains that during the period 1850-1910, a tremendous growth was recorded in the money value of the "supply of active capital" in the US. Not only was there an increase in the aggregate capital, but the per capita value of active capital also grew steadily between 1850 and 1910. However, King concludes: "Only in the Civil War period has this apparent increase been due wholly to changing prices." See Willford I. King, The Wealth and Income of the People of the United States (New York: Macmillan Company, 1915), p. 43.

King's argument does not invalidate Hansen's thesis discussed above.

[2] A. E. Fearveryear, The Pound Sterling (London: Oxford University Press, 1931), pp. 91-108.

As might be expected the first line of argument owes its inspiration to the experience of economic development under capitalist enterprise. Economists belonging to this group argue that when development projects are to be undertaken, if enough savings (both domestic and foreign) are not available, and frequently they are not, a part of investible funds can be made available through the creation of money. The consequent increase in the purchasing power would tend to raise prices. Such a rise would, however, not be cumulative but self-destructive since after a time lag the output of commodities would begin to rise, and the rise in prices would thus be matched by higher levels of output.

It is important to observe that the essential difference between "savings-financed" and "created-money-financed" investment is not in the ultimate effects on output, but rather in the immediate effects on the behavior of prices. How much the prices would rise would of course depend upon the magnitudes of the flow of money and the flow of commodities. As Rao observes, it would be unwise to assert that the creation of money for real investment would always result in inflation; much would depend upon the amount of money created, variations in cash holdings, the amount of marginal income saved, and the changes in the volume of output.[1] However, as various United Nations studies have repeatedly pointed out, although it is probably not possible to have rapid economic development without some inflation there is almost always a great temptation on the part of the government to "overexpand" the money supply in an anxiety to reach the goal of development in a hurry. And "it is also clear that under-developed countries have much to lose from inflation."[2]

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[1] Sampat Pal, "Some Aspects of Monetary Policy and Fiscal Policies for Economic Growth in Underdeveloped Countries," Indian Journal of Economics, XXXVI (July, 1956), 126.

The second argument relates to what might be called the "employment thesis." It is contended by the advocates of this thesis that the fundamental economic problem faced by underdeveloped countries is not merely that of development, the problem is also one of employment; since most of these countries have surplus manpower which must as well be provided with employment. Underdeveloped countries are primarily agricultural; they are short of land and capital but always have surplus manpower in the agricultural sector. Transfer of surplus manpower, it is argued, from the rural areas will not, in the short run, result in a fall in the agricultural production. Instead, it will result in a rise in the agricultural production if irrigation, manuring, seed selection, technical methods of cultivation, etc., are improved. And, in the long run it will result in profitable agriculture and will render further improvements in agriculture possible. On the other hand the surplus manpower can be employed in construction activity to build social overhead and other kinds of development projects.[1] Money may therefore be created to finance such activities. The prices may rise, but they are not likely to rise as much as they would otherwise if there were no surplus manpower in agricultural industry.

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[1] V. K. R. V. Rao, op. cit., pp. 16-17.

[2] United Nations, Measures . . . , p. 42.

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[1] Of course, a shift of labor from agriculture to industry will not necessarily lead to an increase in production, because underdeveloped countries are short of capital resources without which the productivity of labor cannot materially improve.

The reason is not far to seek. In underdeveloped countries a shift of surplus manpower from agricultural industry to other industries only leads to a monetary expansion without a corresponding decline in the agricultural output. This is due to the fact that the marginal productivity of the surplus manpower in the agricultural industry is negligible (and sometimes even negative) and their removal from this industry does not materially affect the total productivity. Thus, if money is created to pay for the workers engaged in agricultural operation to be shifted to more productive activities prices will rise moderately in the initial stage. At a later stage, when the output increases the equilibrium will be restored.[1] Here again it is important to recognize that although potentially the existence of underemployment offers to underdeveloped countries an opportunity for rapidly expanding annual output, the opportunity cannot be seized until some new source of capital can be found to provide the equipment with which the underemployed are to work. Either domestic consumption must fall, relative to output, or foreign investment must become available.

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[1] This approach owes its inspiration to the experience of the USSR. See Maurice Dobb, "Some Aspects of Economic Development," Occasional Papers (No. 3), Delhi School of Economics, Delhi: Privately Printed, 1951. Dobb does not give any proof for shifts of money supply and labor in developed and underdeveloped economies. No such attempt is made here, since this is outside the scope of this study.

What has been said above does not disprove the fact that money plays an important role in economic development. In fact there are two distinct possibilities for financing capital formation by creating money.[1] The first arises out of the fact that if capital equipment could somehow be found to employ some of the unemployed persons, and if new money were then created to pay their wages in producing consumption goods, then these workers would save part of their incomes,[2] and their money savings could be used[3] to pay additional workers to produce capital goods. Secondly, as underdeveloped countries develop, the demand for money increases steadily even when no inflation is occurring, either because of the growth of the national income or because of the expansion of the financial sector of the economy. This secular increase in the financial assets progressively increases the savings[4] power of the community. An increased savings of the community represents, at least partially, an annual addition to the borrowing powers of the government which can be safely used to finance the capital formation. All this discussion leads to the view that an increase in money supply is not only consistent but prerequisite to an accelerated economic development.

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[1] United Nations, Measures . . . , p. 43.

[2] It is assumed that the marginal propensity to consume is less than unity.

[3] It is assumed that the savings made by these workers could be successfully mobilized.

[4] Savings refers here to money savings.

The responsibility for creating money for developmental purposes falls on the government of an underdeveloped country. The government can increase the money supply either by printing currency or by creating credit. Each of the two methods is discussed separately in the following pages.

Under the traditional monetary systems growth in the money supply (that is, currency and demand deposits) was invariably linked with the accumulation of gold or foreign exchange as a monetary reserve. Even with a more flexible monetary system most countries base their money expansion on some type of proportional reserve system, that is, gold or foreign exchange reserves equal to a certain percentage of currency in circulation. This is deemed necessary not only to give prestige to the money in circulation but in underdeveloped countries this system also serves an additional function. As economic activity increases it leads to increased production and a pari passu expansion in foreign trade. The foreign exchange assets which are held as backing for note issue can then be used for smoothing out larger fluctuations in foreign exchange receipts and payments. It therefore seems evident that the linking of the growth in the money supply with the accumulation of gold or foreign exchange reserves also sets a limit to the government's power of money creation.[1]

The other, and perhaps more popular, alternative mode of an increase in the money supply is the creation of credit which can take various forms. The government can borrow from the public, from the commercial banks, and finally, from the central bank. The effects of these three forms of borrowing are different in character and need to be examined separately.

When the government borrows from the public one of three things can happen. In the first case, if this money represents that part of the money income which, if left to itself, would probably have been spent on consumption the effect is to channel the "consumption money" into desirable investment. There is no effect on the total money supply, and the velocity of circulation might also remain unaffected. As a result the price level might also remain unaffected.

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[1] The government can, however, expand the money supply if the "Proportional Reserve System" is replaced by some type of "Fixed Reserve System" where the authorities are required to keep only a fixed amount (rather than a flexible percentage) of foreign exchange assets against an unlimited supply of money. This was done in India in 1956 to enable the monetary authorities to create credit for financing the Five Year Plans.

Secondly, if the government is able to attract public hoardings, which are in some periods as large as 10 per cent of the national income, idle balances are brought into circulation. Thus, although the total money in circulation still remains constant, since the idle money is activated the velocity of money is likely to increase. In this case the government is able to attract money for capital formation without decreasing consumption. However, it is very likely that this type of borrowing will push up the price level since the velocity of money would probably increase. It is also conceivable that this price increase will be accompanied (with a time lag) by increased production resulting from a higher rate of capital formation by the government.

In the third case, the government may also borrow voluntary savings from the public, which would otherwise have been utilized to finance private investment. The economic effect of such a borrowing is to encourage public investment at the cost of private investment. The net effect of such a borrowing on the price level cannot be accurately predicted, for that would primarily depend upon the difference between the income-inducing effects of public investment and the income-reducing effects from the drawing off of spendable income from the private sector.

The effects of borrowing by the government from commercial banks and from the central bank are somewhat similar and may be examined together. As has been noted earlier, in underdeveloped countries owing to the paucity of adequate savings institutions it is difficult for the government to attract private savings. It is comparatively easier, and much more effective, for the government to borrow money from the banking system. Assuming that the government wants to borrow money with the immediate objective of investing it in socially "desirable" projects, this form of borrowing has the immediate effect of increasing the money supply. In such a situation borrowing from either the central bank or commercial banks has similar effects on the total money supply.

Two important differences in this connection should, however, be noted. First, in most countries borrowing from the central bank will expand commercial bank reserves and thereby lay the basis for a multiple expansion of the money supply. This will not be the case if the borrowing is done from the commercial banks. Second, while the government cannot force the commercial banks to invest their money in government bonds and securities it may dictate that the central bank does so, thereby expanding the money supply to the desired extent.

To summarize, the government has the ultimate responsibility of expanding the money supply to undertake development financing. The government can do so by borrowing from the public, from commercial banks, or from the central bank. Borrowing from the public does not materially result in the creation of credit. Borrowing from commercial banks, on the other hand, results in an expansion of credit, but the government cannot force the commercial banks to create the desired amount of credit. Consequently the government usually meets the responsibility of expanding the money supply through the central bank of the country, which can be directed to assist the government in this task. However, an extension of the central bank credit to the government in the form of currency expansion may require an increase in the foreign exchange holdings of the Bank. The government may in these circumstances unlink the foreign reserves from the note issue and thereby pave the way for a smoother monetary expansion.

The Role of the Central Bank in Economic Development

Most central banks consider the supply of money as their important responsibility and thereby directly contribute to economic development. Sometimes, however, this responsibility to contribute to economic development is overemphasized, in which case it is fraught with inflationary dangers. For instance, the Governor of the State Bank of Pakistan said not too long ago:

> Though the threat of excessive money supply has to be guarded against, the central bank at the same time has to ensure that there is no lack of funds for meeting genuine requirements in any sector of the economy. Paucity of credit facilities leads to bottlenecks in production and fuller utilisation of resources. It is, therefore, the duty of the central bank to see that each of the various sectors of the economy is provided with an appropriate volume of credit facilities. *The role of the* . . . [central bank] *in the country's economic development is to be judged in this perspective*.[1] (Italics supplied.)

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[1] A. Qadir, *State Bank of Pakistan Bulletin*, September, 1955, p. 34. (Speech delivered at the Seventh Annual General Meeting of the State Bank of Pakistan at Lahore, September 8, 1955.)

It may be noted that although the Governor speaks about the responsibility of the central bank to provide "an appropriate volume of credit" he seems to subordinate the central bank's regulatory function to its responsibility of creating credit. And if the central bank is held responsible for supplying credit with a view to stepping up the rate of investment through forced savings resulting from inflation, then instead of controlling the inflation generated by the government's development programs it would aggravate the situation further.

It is in this perspective that the role of the central bank vis-a-vis the government must be viewed. In underdeveloped countries the root of most inflationary evils lies in a deficit in the governmental budget which is financed by the creation of new money. With a view to stepping up the rate of investment relative to available savings governments have a tendency to overextend their position beyond their normal capacity. Once the targets of development are set there arises the problem of accumulating necessary finances. There are, as mentioned before, almost always limitations to the collection of sufficient revenues either because the tax structure is inadequate or because the tax laws are not enforced effectively.

Inefficiency in the execution of governmental plans might also limit the capacity of the government to muster sufficient resources. In short, whenever the government of an underdeveloped country plans to spend an amount larger than the revenues available to it, it must borrow or create credit to fill the gap.[1] But unfortunately here too the possibilities open to the government are strictly limited, owing primarily to the undeveloped nature of the country's capital and money markets. Of necessity the institutions for collecting the savings of the people are rudimentary. The credit of the government in many cases is not securely established. Moreover the currency might be depreciating so that no fixed obligation stated in that currency might be easily salable. If, then, the government still decides to implement its development plans, it is forced to demand of the central bank the creation of new money for its purposes since that is a more subtle, and perhaps easier, form of expanding the money supply. The central bank thus becomes directly instrumental in providing further impetus to inflation.

The inflationary chain reaction that is set into motion as a result of the expansion in the money supply in an underdeveloped country is well known and may be summarized here briefly. As too much money begins to chase too few goods the cost of living rises which in turn aggravates the demand for higher wages. This results in the "cost-push" type of inflation which in turn pushes the prices further. The government intervenes through price controls to limit the rise in prices of essential commodities, especially food articles. This leads to distortions in the market and in many instances develops "black markets," creating new shortages and price pressures. In many instances the government attempts to restore production through subsidies, thus creating a new source of budgetary deficits.

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[1] To the extent the government can secure external assistance, however, the gap is reduced.

In the circumstances described above all imported commodities become cheap (unless the government takes the very bold step of devaluing the currency) and imports begin to expand. Simultaneously production for export ceases to be remunerative in the face of rising costs, resulting in the loss of markets. The combined effect of the above is the creation of a heavy drain upon the country's gold and foreign exchange reserves. The decline in reserves further undermines confidence in the currency and reduces the ability of the government to carry on developmental programs through heavy imports of capital goods. As a result shortages appear in various types of goods essential to domestic production. In addition the availability of capital goods necessary for investment in productive industrial and agricultural enterprises progressively declines.

While most parts of the economy tend to be adversely affected by these developments those, for example, who deal in commodity speculation mainly using borrowed money, tend to gain. It is true that speculative activities in themselves are not necessarily bad; in a situation such as described above, however, these activities further intensify the inflationary pressure. Government is then forced to discourage such disruptive speculation through direct controls which begin to distort the resource allocation.

The combined effect of these inflationary forces is that in many instances "after an initial increase . . . for perhaps two or three years, socially productive investment may revert to an even lower level than prevailed prior to the inflation."[1] But what is worse still is that there is almost always a tendency on the part of the government to be continuously driven toward resorting more and more to bank credit in order to meet the higher level of money demands originating from the development programs already on hand and those scheduled for the immediate future. The obvious consequence is an expansion of the money supply which may fortify the prime cause of the original inflation.

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[1] International Monetary Fund, Economic Development with Stability, 1953, p. 5.

All that has been said above, however, while ruling out inflation as a deliberate developmental policy, does not imply that there is no scope for central bank credit creation as such. To the extent that voluntary savings tend to occur in the economy but are not placed at the disposal of productive users, central bank credit can offset the contraction in the income stream which would otherwise result from hoarding. The most familiar example of such saving in an underdeveloped economy is hoarding in the form of currency notes. This may result from the absence of banking facilities or lack of confidence in financial intermediaries. But even when monetary savings are deposited in the banking system there still exists the possibility, given the institutional characteristics of the money market in most underdeveloped countries and the traditional preference of the banking system for short-term commercial finance, that the intended saving might not be mobilized because of the bank's failure to advance credit to certain needed fields of activity. The monetary policy by making credit available for these uses may help to implement the society's decision as to the proportion of its income to be invested.

Another argument that may be advanced in favor of deficit financing is that "some deficit financing is consistent with a sound credit policy . . . to facilitate economic development."[1] This is because deficit financing is not always inflationary, although it is always expansionary. This situation holds true whether one accepts the general definition of deficit financing or deficit financing in the Indian sense. As regards its inflationary potential, it may be noted that deficit financing, which takes the form of borrowing by the government, can be either inflationary or non-inflationary. If the government borrowing represents voluntary savings of the community, it is non-inflationary in character. But where the significant economic act is compulsory or forced saving induced by a rise in prices and a corresponding devaluation of income the borrowing of necessity would be inflationary, investment having exceeded voluntary savings of the community. Direct expansion of the money supply through the printing of notes, too, can be non-inflationary if the national product (in real terms) increases pari passu with money supply, or if the deficit spending is matched by an import surplus of consumer goods. This, of course, is unlikely since the gestation period in any process of capital formation of an under-developed country would involve a certain time lag; also there does not exist much scope for import surplus of consumer goods since accelerated development calls for heavy imports of capital goods.

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[1] International Monetary Fund, op. cit., p. 43.

While borrowing from the public (including the banking system) and direct monetary expansion by printing of currency can either be inflationary or non-inflationary it does not follow that the effects of both are similar on the economy. As a matter of fact in most instances such is not the case. The printing of currency carries with it the greater inflationary dangers. This phenomenon invokes further interest in view of the fact that the former method is more widely used in developed nations, while instead of credit creation by commercial banks, direct money creation (through the printing of notes) is a more common characteristic of undeveloped countries. In Western nations, owing to highly developed banking habits, borrowing by government usually takes the form of bank credit expansion. In underdeveloped countries, on the other hand, deficit financing frequently results in currency expansion, because governments in these countries find it difficult to tap the already low levels of savings and also because savings institutions are not well developed.

The differences in the effects of these two methods of credit creation on the economy are profound. For instance, in the case of credit creation by banks certain limitational factors restrict banks from unlimited expansion of their credit. By way of an illustration, banks are often limited in their lending operations by the conventional advances-deposits ratio that might be ruling in the economy.[1] They also have to observe safety rules while granting advances against certain assets pledged by their borrowers. None of these restrictions applies to currency expansion by the government; the only possible restriction imposed on the government is the prudent and careful adaptation of its policies to prevent ill effects of currency expansion. In case the currency expansion is limited by the gold and foreign exchange reserves of the government such a limitation can be overcome, as mentioned before, by suitably amending the law, necessitating the holding of reserves of only a fixed amount and freeing the government from the restrictions on note issue.[1] In short, there are no "safety valves" fitted to the currency printing machines.

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[1] It should be recognized that the advances-deposits ratio prevailing at any time may change with the development of the economy.

Besides monetary expansion there are additional technical grounds for believing that the danger of inflation stemming from deficit financing in an underdeveloped economy is great. In underdeveloped areas, while the initial monetary investment leads to an increment in money income the higher money income in turn does not automatically lead to an increment in the real income. The reason is that the value of the multiplier connecting the increase in real investment to real income and output is reduced close to unity because of the absence of idle capital resources in consumer goods industries. Moreover, the supply curve of output of a developing economy is far from elastic. In fact the agrarian character of the economy makes the supply curve virtually inelastic. The situation would appear to be far worse if it is recalled that while on the one hand the demand for consumption goods is intensified owing to high propensities for consumption, on the other, the supply of consumer goods does not increase correspondingly. Thus, in the early stages of development at low income levels the propensity to consume is high and the output elasticity is low, resulting invariably in the generation and intensification of inflationary pressures. In view of these reasons, the scope of deficit financing in developing nations would appear to be limited.

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[1] It may be pointed out here that underdeveloped countries have an advantage over developed nations insofar as the creation of bank credit is concerned. For, in the former countries, there are limitations to the multiple credit creation by banks, which is a common characteristic of banking in developed nations. See John M. Keynes, A Treatise on Money (New York: Harcourt, Brace and Company, 1930), I, 22-30.

Monetary Policy and Economic Development

Our foregoing analysis throws one fact into bold relief. As compared to other methods of financing the deficit method of financing economic development carries with it a larger inflationary potential in underdeveloped countries. This means that if the underdeveloped countries decide to bring about a rapid economic development with the help of deficit financing and the governments of these countries are constrained to rely heavily on the central bank credit, the regulatory function of the monetary authorities will assume special importance. This is so because these nations do not fancy just any kind of development, but only such a development which is attainable with a certain degree of *stability*.

We would call this regulatory function of the monetary authorities as the *restrictive* role of monetary policy. This might also be called the *short run objective* of controlling inflation. More specifically, when the government decides to pursue the inflationary methods of financing development monetary policy is charged with the responsibility of controlling the "new" inflation generated in the economy. The authorities then have not only to use the quantitative instruments of credit policy more vigorously, but also have to be versatile in developing qualitative controls best suited to the needs of the particular stage of development.

Besides the restrictive aspect, monetary policy has also the developmental role to play. The developmental role, which may be called the *long run objective* of developing financial institutions relates to the inducement of savings and investment through the development of monetary and credit institutions, improvement of the technique of control, monetization of the market, training of personnel, and enlargement of the scope of the monetary policy in every possible way. While in the development phase the restrictive role of the monetary policy would appear to be of prime importance, the developmental role is also important. The reason is that in the ultimate analysis the effectiveness of the monetary policy in its former role would depend mainly upon the success with which it performs its developmental role.

An important feature of the underdeveloped economies which affects the effectiveness of monetary policy is that in most of these countries the money supply primarily consists of currency in circulation, while bank deposits form a very insignificant portion of the money supply. The community is not very familiar with the use of credit instruments and there is an absence of any broad organization of agencies to distribute "finance" to those who need it for investment purposes. This lack of a deposit habit on the part of the people makes it difficult for the central bank to influence the economy by controlling the banking system. On the other hand since the bulk of the money supply is in the form of currency the central bank can regulate with greater efficiency the rate of spending by affecting the currency in the desired direction.

Another reason for the importance of monetary policy in underdeveloped countries is that in these countries an increase in the quantity of money is required, as stated above, not only because of the growth of production but also because of the enlargement of the "monetized" sector of the economy. Because of the existence of a major non-monetized sector in the economy, restrictive credit policies may force transactions out of the monetized into the non-monetized sector while leaving prices within the monetized sector as high as before. Thus, for such an economy an appropriate monetary policy can conceivably control, to some extent, a general price rise without retarding production significantly. This way, monetary policy can be made to play a role which will keep the long run tendencies of the economy consistent with the requirement of economic stability.

To summarize, monetary policy in a developing economy has a dual role to play: the restrictive role, consisting of the short run objective of controlling price inflation generated by the deliberate deficit financing by the government; and the developmental role, consisting of the long run objective of developing financial institutions. Clearly there is no magic formula by which the monetary authority can determine in advance the course of action that will satisfy both objectives at all times. In fact there does frequently arise a conflict between the short run and the long run objectives of monetary policy. On such occasions it would call for the re-evaluation and conceivably a realignment of the monetary policy with the total economic policy of the country, with the prime objective of achieving the desired goals set by the community in the most efficient way. In the final analysis an appropriate monetary policy in the context of economic development of an underdeveloped economy will need to concern itself with the development of a financial system which will prevent inflation or deflation without impeding the adjustment of production and prices, which constantly goes on in a dynamic economy. Simultaneously the policy will have to be selective enough to influence the pattern of investment in the desired direction. And finally, the monetary policy will have to be formulated in a way which will function effectively as an integral part of the total economic policy.

It seems appropriate at this stage to consider briefly the arguments for and against the use of active monetary policy in accelerating economic development.

The case against active monetary policy in economic development

Today there are many economists who believe that all roads pointing to economic development lead to inflation anyhow. And since the active monetary policy is likely to be expansive the contribution which monetary authorities can make in situations of economic development is simply to maintain stability from day to day, ignoring an opportunity to affect the course of development. This skepticism of economists stems not so much from the inherent limitations of monetary policy as from the belief of many responsible leaders that inflation is a useful or indeed indispensable stimulant to the economy and that progress can invariably be accelerated through a kind of forced saving. A reaction against this preference for inflationary financing has led many economists to emphasize stability rather than growth. The achievement of stability, according to them, brings growth as a by-product. The duty of the authorities, therefore, should be to ignore, or pay only slight attention to, the requirements of growth, and to concentrate attention on stability.[1]

The case for active monetary policy in economic development

There are a large number of economists who strongly believe in the active role of monetary policy in the context of economic development. These economists argue that monetary policy must be used to provide the "correct amount of money" consistent with higher levels of economic activity. The increased demand for money comes from a number of sources. First, the extension of the money economy at the expense of the subsistence sector requires a stock of money to satisfy the transactions demand for money on the part of the new entrants. Second, as economic activity increases there is likely to be an increase in the demand for money for ordinary transactions; since with economic activity income per capita and the numbers of people rise. Third,

> . . . in the later stages of development, a diversification demand for money . . . arise[s]. Growth brings an increase in financial assets, as deficit-spending units [which invest] issue debt or equity securities to surplus-spending units [which save].[2]

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[1] See especially the views of Howard S. Ellis, commenting on Charles R. Whittlesey, "Relation of Money to Economic Growth," _American Economic Review, Papers and Proceedings_, XLVI (May, 1956), 206-10.

[2] Kindleberger, _op. cit._, p. 191.

Therefore one of the major tasks of the monetary authorities in development should be to support the gradual expansion and diversification of the machinery -- commercial banks, savings banks, investment banking, insurance companies, government bond market, private bond and share markets, etc., -- which link surplus and deficit-spending units.

Conclusion

In recent years monetary policy has been coming more and more into the limelight all over the world following a period of relative eclipse. During the throes of the Great Depression in the 'thirties, which no doubt called for unorthodox remedies, monetary orthodoxy was progressively abandoned, and even became to some extent discredited. Then during the war years most countries found that the discipline which was required of their economies was so great that it had to be imposed by means of direct economic controls rather than by broader and more general monetary measures. Immediately after the war there was a strong tendency in many countries to perpetuate controls and to reject monetary policy as an instrument for attaining economic stability and balance.

It was precisely during this time that the world experienced a wave of rising nationalism, especially in the countries of Asia and Africa. Following independence, the governments of most of these countries felt the strongest compulsion to accelerate their economic development in order to meet the clamor of their peoples for improved living standards. That the underdeveloped countries should try to find opportunities in the manipulation of money is understandable; since because of lack of experience in formulating and administering economic and financial policies it was thought that the comparatively easier policy of monetary manipulation could offer a royal road to development. Experience shows, however, that in the early stages of development the change-over from a specie to a fiduciary coinage gives a once-and-for-all opportunity for spending; and this is followed as the monetary base grows with further widening and deepening of opportunities. There is also enough empirical evidence to show that the money supply grows with economic development, not only proportionally but at a faster rate.[1] The experience of most developing nations in their attempts to follow expansionary policy has therefore been devastating. Most underdeveloped countries have had their bout of inflation and have passed through periods of acute financial disorders. It is currently being realized that an injudicious application of monetary policy to feed the deliberately created budget deficits of governments determined to achieve high rates of economic growth within the shortest possible time faces the most serious danger of creating "inflationary disorders." However experience shows that, judiciously used, monetary policy also helps immensely in obtaining both the short- and long-term objectives of economic development. Underdeveloped nations are therefore beginning to evaluate the role of monetary policy in the context of their economic development in its true perspective. And that is as it should be. The ultimate objective of every developing nation should be not pursuing just any kind of monetary policy, but only a policy which will play both its restrictive and developmental roles, be consistent with the total economic policy of the country, and, finally, bring about economic development with stability.

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[1] *Ibid.*, p. 197.

CHAPTER VII

MONETARY POLICY IN INDIA: THE RESTRICTIVE ROLE

In the last chapter it was observed that the monetary authorities in any developing economy have to play a dual role: the "restrictive" role and the "developmental" role. In this chapter an evaluation will be attempted of the restrictive role of monetary policy in India. The developmental role will be discussed in chapter VIII. The restrictive role of monetary policy, it may be recalled, refers to the monetary policy designed to control or moderate the "new" inflation generated by the accelerated development programs in an underdeveloped economy.

The Cause of New Inflation

The monetary authorities in India have always recognized that

> . . .one of the primary responsibilities of the Reserve Bank is to handle the monetary mechanism in such a way as to preserve the

> stability of the national currency . . . if the currency became unstable and depreciated in value, the Bank would lay itself open to the charge that it had failed in carrying out its responsibility.[1]

This feeling of responsibility is not confined to the central bankers of underdeveloped countries alone. Even in a most advanced country like the USA the maintenance of the value of the dollar is frequently emphasized. Thus W. M. Martin, Chairman of the Board of Governors of the Federal Reserve System, recently observed:

> What a correct monetary policy can do is to foster confidence in the dollar, so that our people can and will save and invest in the future with reasonable assurance that their plans will not be frustrated by irresponsible changes in the value of money.[2]

It is in this spirit that the restrictive role of monetary policy in India has to be evaluated.

In chapter IV a survey of economic developments that took place in India during the period April, 1950, through March, 1960, was made, which incidentally coincided with the last pre-Plan year (1950-51), the First Plan period

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[1] H. V. R. Iengar, "Some Reflections on Our Domestic Economy," Reserve Bank of India Bulletin, XIII (January, 1959), 11. (A talk given to the Commerce Graduates' Association at Bombay, January 7, 1959.)

[2] William M. Martin, "Monetary Policy and Economic Growth," Federal Reserve Bulletin, XLVI, Nos. 1-6 (February, 1960), 132. (Statement made before the Joint Economic Committee, Washington, D. C., February 2, 1961.)

(1951-52 to 1955-56), and the first four years of the Second Plan period (1956-57 to 1959-60). A critical analysis of the economic development in India during the above period is now undertaken.

During the ten-year period ending March, 1960, the national income of India at constant prices increased by 33.3 per cent, or at an annual average rate of 2.89 per cent, compounded, and the per capita income by 10.0 per cent, an average annual rate of 1.0 per cent, compounded. An account of the variations in the national income and the per capita income during the period 1949-50 to 1959-60 is given in Table 36. It reveals that during the year 1959-60 the national income at constant prices increased by a nominal 0.9 per cent as compared with an increase of 7.0 per cent during the year 1958-59. Over the first four years of the Second Plan, 1955-56 to 1959-60, the national income (at constant prices) rose by 12.2 per cent, or at an annual average rate of 2.9 per cent, as against a rise of 18.4 per cent during the First Plan period (1950-51 to 1955-56), or an annual average rate of 3.5 per cent. It is also interesting to note that the net rise in the national income during the nine years of the Plan period (1950-51 to 1959-60) was of the order of

TABLE 36

NATIONAL AND PER CAPITA INCOMES IN INDIA DURING THE PERIOD 1949-50 TO 1959-60

Year	National Income		Per Capita Income[a]	
	Million Rupees		Rupees	
	At 1948-49 Prices	At Current Prices	At 1948-49 Prices	At Current Prices
1949-50	88,200	90,100	248.6	253.9
1950-51	88,500	95,300	246.5	265.5
1951-52	91,000	99,700	248.6	272.4
1952-53	94,600	98,200	253.6	263.3
1953-54	100,300	104,800	263.9	275.8
1954-55	102,800	96,100	264.9	247.7
1955-56	104,800	99,800	264.6	252.0
1956-57	110,000	113,100	272.3	280.0
1957-58	108,900	113,900	264.3	276.5
1958-59	116,500	126,000	276.1	298.6
1959-60[b]	117,600	128,400	273.5	298.6

Source: Reserve Bank of India Bulletin, Statement 58A (May, 1961), p. 829.

[a] Assuming average annual rate of population increase of 2.0 per cent, compounded. For the rate of population increase see Reserve Bank of India Bulletin (June, 1961), p. 901.

[b] Preliminary.

32.9 per cent, or an annual average rate of 3.3 per cent, compounded.

Per capita income (at constant prices) based on the 1961 census figures, it may be observed, worked out to Rs. 273.5 for 1959-60 as compared to Rs. 276.1 for 1958-59, Rs. 264.6 for 1955-56, and Rs. 246.5 for 1950-51. The per capita income at constant prices increased from Rs. 264.6 in 1955-56 to Rs. 273.5 in 1959-60, that is, a rise of 3.4 per cent over the first four years of the Second Plan, while the net rise in the per capita income over the two Plan periods (1950-51 to 1959-60) was 11.0 per cent.

While the national income and the per capita income showed only moderate gains in real terms, they showed considerable improvements expressed in terms of current prices. Thus, at the end of March, 1960, the national income at current prices stood at Rs. 128,400 million as against Rs. 99,800 million before the commencement of the Second Plan (1955-56), and Rs. 95,300 million on the eve of the First Plan (1950-51). Percentagewise the national income at current prices showed a rise of 42.5 per cent during the nine-year period 1950-51 to 1959-60 as compared to a rise of 33.3 per cent at constant prices over the same period. The per capita income at current prices, on the other hand, showed an increase of only 17.6 per cent as against an increase of 10.0 per cent in the per capita income (at constant prices) during the above period.

To conclude, the national income data reveal that during the nine-year period the increase in the national income in monetary terms was substantially more than the increase in the national income in real terms. It would therefore seem legitimate to examine how far the inflation in the Indian economy could be traced to "monetary" factors; since inflation generated by "non-monetary" factors would fall outside the scope of monetary control, and would consequently fall beyond the scope of this study.

With this objective in view the price situation in India during the period 1950-51 to 1959-60 may now be examined. In Table 37 details of selected economic indicators during the period 1949-50 to 1959-60 are given.

Over the entire ten-year period ending in 1959-60 the wholesale price index rose from 101.3 to 117.1, a total increase of 15.6 per cent and an annual average rate of 1.4 per cent, compounded. During the nine Plan years, the index rose from 107.6 to 117.1, a total increase of 8.8 per cent. In the five years 1950-51 to 1955-56 the wholesale price index dropped from 107.6 to 92.5, a fall

TABLE 37

INDICES OF SELECTED ECONOMIC INDICATORS DURING THE PERIOD 1949-50 TO 1959-60

(1952-53 = 100)

Year	Wholesale Price	Money Supply	Nat'l Income	Per Capita[a] Income
			At 1948-49 Prices	
1949-50	101.3	105.7	93.2	98.0
1950-51	107.6	112.2	93.6	97.2
1951-52	114.1	102.2	96.2	98.0
1952-53	100.0	100.0	100.0	100.0
1953-54	101.2	101.7	106.0	104.1
1954-55	97.4	108.8	108.7	104.5
1955-56	92.5	123.8	110.8	104.3
1956-57	105.3	131.1	116.3	107.4
1957-58	108.4	135.4	115.1	104.2
1958-59	112.9	141.6	123.2	108.9
1959-60	117.1	153.1	124.3	107.8

Sources: Reserve Bank of India, Report on Currency and Finance, 1949-50 through 1959-60; Reserve Bank of India Bulletin (May and June, 1961); Government of India, Central Statistical Organization, Estimates of National Income, 1948-49 to 1957-58, April, 1959.

[a] The index of per capita income has been calculated on the basis of a population increase of 2.0 per cent, compounded annually.

of 14.0 per cent. In the four years 1955-56 to 1959-60 the index rose from 92.5 to 117.1, an increase of 26.6 per cent. Thus the years 1950-51 through 1959-60 fall into two broad periods -- that of falling prices (1950-51 to 1955-56) and that of rising prices (1956-57 to 1959-60).

The first component of the wholesale price index with intriguing behavior is food articles, as revealed by Table 38. It is observed that during 1950-51 the rise in the prices of food articles was 6.4 per cent. Then the index began to fall, at first by 4.3 per cent in the following year (1951-52) and then suddenly by 12.6 per cent in 1952-53 with a further fall of 5.5 per cent in 1954-55 and 8.5 per cent in 1955-56 -- in all a fall of 25.6 per cent over the First Plan period (from 1950-51 to 1955-56). Since then the index of food articles prices persistently rose, increasing from 86.6 in 1955-56 to 119.0 in 1959-60, a total rise of 37.4 per cent over the first four years of the Second Plan.

In contrast to food articles, with a few exceptions the manufactures group recorded less fluctuation. Prices of these articles suddenly jumped up in 1951-52 by 13.4 per cent due presumably to the Korean War boom; in the following year (1952-53) these prices fell by as much as 7.8

TABLE 38

INDEX NUMBER OF WHOLESALE PRICES DURING THE PERIOD 1949-50 TO 1959-60

(1952-53 = 100)

Average of Months	All Commodities (1000)		Food Articles[a] (504)		Manufactures (290)	
	Index No.	% Change over Previous Year	Index No.	% Change over Previous Year	Index No.	% Change over Previous Year
1949-50	101.3		109.4		103.8	
1950-51	107.6	+ 6.2	116.4	+ 6.4	95.4	- 8.1
1951-52	114.1	+-6.0	111.4	- 4.3	108.2	+13.4
1952-53	100.0	-12.4	100.0	-12.6	100.0	- 7.8
1953-54	101.2	+ 1.2	100.1	+ 0.1	100.4	+ 0.4
1954-55	97.4	- 3.8	94.6	- 5.5	100.6	+ 0.2
1955-56	92.5	- 5.0	86.6	- 8.5	99.7	- 0.9
1956-57	105.3	+13.8	102.3	+18.1	106.3	+ 6.6
1957-58	108.4	+ 2.9	106.4	+ 4.0	108.1	+ 1.7
1958-59	112.9	+ 4.2	115.2	- 8.3	108.4	+ 0.3
1959-60	117.1	+ 3.7	119.0	+ 3.3	111.6	+ 3.0

Source: Reserve Bank of India, Report on Currency and Finance, 1949-50 through 1959-60.

Note: Figures in parentheses are weights assigned to each group.

[a] Food Articles comprise foodgrains, milk, and shortening.

per cent. Since then (except for 1956-57) prices of the manufactures group showed moderate fluctuations as compared to food articles. Over the First Plan period the index of the prices of manufactured articles increased from 95.4 in 1950-51 to 99.7 in 1955-56, or a total rise of 4.5 per cent. Furthermore the index increased from 99.7 in 1955-56 to 111.6 in 1959-60, or a total rise of 11.9 per cent over the first four years of the Second Plan.[1]

It may be pertinent to note here that because of the agrarian character of the Indian economy an increase in the wholesale price index is frequently the result of an increase in food prices. However, the character of inflation that developed in the Indian economy especially during the latter part of the Second Plan was different in that all prices, and not only those in the food group, shared the price increase, as shown by Table 39. This new character of inflation was very significant since it appeared to represent "true inflation."[2] An overall rise

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[1] In the wholesale price index, food articles carry a weight of 50 per cent of the total weight, while the manufactures group is assigned 20 per cent of the total weight.

[2] True inflation has been defined in chapter VI.

TABLE 39

INDEX NUMBER OF WHOLESALE PRICES DURING SELECTED YEARS

(1952-53 = 100)

	1958				
	Jan. 25	Mar. 29	June 28	Sept. 27	Dec. 27
Food articles (504)	102.2	103.4	116.1	120.6	112.2
Liquor and tobacco (21)	96.0	94.4	92.6	91.3	97.8
Fuel, power, light and lubricant (30)	114.4	114.5	115.5	116.0	115.0
Industrial and raw materials (155)	112.8	112.9	115.8	117.3	111.2
Manufactures (290)	107.5	107.3	108.5	108.9	107.9
All commodities (1000)	105.6	106.1	113.3	116.1	110.8

Source: Reserve Bank of India, Report on Currency and Finance, 1957-58, 1958-59, and 1959-60, Tables 19, 19, and 18, respectively.

Note: Figures in parentheses represent weights assigned to each group.

TABLE 39 -- Continued

1959					1960	
Jan. 31	Mar. 28	June 27	Sept. 26	Dec. 26	Jan. 30	Mar. 26
116.2	112.7	118.5	121.9	117.6	117.6	116.5
106.1	98.9	99.0	100.2	116.7	98.2	97.1
114.9	115.6	115.9	116.2	102.5	117.8	117.3
116.9	115.9	120.2	122.8	117.0	132.6	132.0
108.6	108.3	109.3	110.1	129.2	116.4	116.7
113.7	111.7	115.6	118.0	114.2	119.2	118.6

which is the result of a rise of one or two items is, to use the terminology of Gardiner C. Means, a "rotation" around particular figures which might give the impression of an overall rise but does not, in fact, represent the pressures of inflation. The new phase of inflation perhaps revealed a true "translation" of prices in place of a rotation around food prices.

At this point we may summarize the behavior of wholesale prices during the nine-year Plan period. General prices in India declined by 14.0 per cent during the First Plan period. Since the inauguration of the Second Plan in April, 1956, until the end of March, 1960, the general level of wholesale prices increased by 26.6 per cent. What was more significant was that the character of inflation also changed; the increase in prices persisted year after year pervading all areas of the economy, and not just the sector of food articles.

At this stage it is pertinent to ask: "Was the inflation generated in the Indian economy during the Plan period a direct result of the expansion in money supply?" No direct answer is possible, for it is difficult to isolate the cause and effect of the inflation under study. However, a comparison of the variations in the money supply with those in wholesale prices during the period under study may provide, within limits, an answer to the above question.

In Table 40 the variations that took place in the money supply and the wholesale price index during the period 1949-50 through 1959-60 are epitomized. No direct relationship is evident between variations in wholesale prices and the money supply over the ten-year period as a whole. And even if a time lag of, say, one year between a change (rise or fall) in the money supply and that in the price level is assumed, variations in the money supply do not appear to have influenced the price level directly over the First Plan period. However, over the Second Plan period (between 1956-57 and 1959-60) a more direct relationship between the two indices would seem to hold. While it is true that in India the inelasticity of the supply of consumer goods (because of the emphasis on industrialization) is a major characteristic of development, and hence the quantity theory of money may become applicable, no definite conclusions in this regard can be reached owing to the inadequacy of statistical evidence. Nevertheless the above table does suggest that since the money supply and wholesale prices moved hand in hand (with a time lag of one year) during

TABLE 40

INDICES OF WHOLESALE PRICES AND MONEY SUPPLY DURING THE PERIOD 1949-50 TO 1960-61

(1952-53 = 100)

Year (Average of Months)	Wholesale Prices		Money Supply	
	Index	% Change over Previous Year	Index	% Change over Previous Year
1949-50	101.3		105.7	
1950-51	107.6	+ 6.2	112.2	+ 6.1
1951-52	114.1	+ 6.0	102.2	- 8.9
1952-53	100.0	-12.4	100.0	- 2.2
1953-54	101.2	+ 1.2	101.7	+ 1.7
1954-55	97.4	- 3.8	108.8	+ 7.0
1955-56	92.5	- 5.0	123.8	+13.8
1956-57	105.3	+13.8	131.1	+ 5.9
1957-58	108.4	+ 2.9	135.4	+ 3.3
1958-59	112.9	+ 4.2	141.6	+ 4.6
1959-60	117.1	+ 3.7	153.1	+ 8.1
1960-61	124.8	+ 6.6		

Source: Reserve Bank of India, Report on Currency and Finance, 1949-50 through 1960-61.

the Second Plan while they followed no systematic pattern during the First Plan, certain factors may have been responsible for such a pattern. Consequently a detailed analysis of the variation in the price level together with the factors affecting such variations seems appropriate, to which we now turn.

In this context it is desirable to analyze variations in the money supply and wholesale prices in relation to changes in the production of foodgrains. The reason for such an analysis is that in India foodgrains truly represent the expenditure pattern of the general masses of people. In India foodgrains constitute over 65 per cent of the country's agricultural production and approximately 25 per cent of her wholesale trade.[1] The expenditure of the urban population on food ranges between 22 and 55 per cent of their total expenditure, while the percentages are unequivocally higher in the case of the rural population.[2] Consequently fluctuations in the production of foodgrains have a profound effect on the nation's economic activity. In fact, very often variations in the availability of foodgrains directly affect wholesale prices in India.

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[1] B. R. Shenoy, "Our Food Problem," Commerce (Annual Number, 1959), p. 50.

[2] *Ibid.*

It has been mentioned earlier that (assuming a time lag of one year between any variation in the money supply and its effect on the wholesale price level) no consistent pattern of variation was evident during the First Plan between changes in the money supply and wholesale prices. For instance, on the one hand the wholesale price index increased by 6.0 per cent in 1951-52 following an increase in the money supply by 6.1 per cent in the previous year. On the other hand there was an increase in wholesale prices of 1.2 per cent in 1953-54 and a fall of 3.8 per cent in 1954-55, while money supply had decreased by 2.2 per cent in 1952-53 and increased by 1.7 per cent in the following year. It is also interesting to observe that while the index of money supply increased from 112.2 in 1950-51 to 123.8 in 1955-56, or a total rise of 10.4 per cent over the First Plan period, wholesale prices were down by 14.0 per cent over the same period.

Table 41 brings out the relative variations in the money supply, wholesale prices, and the production of foodgrains. The table reveals that beginning with the year 1950-51 foodgrain production progressively went up at

TABLE 41

INDICES OF MONEY SUPPLY, FOODGRAINS PRODUCTION, AND WHOLESALE PRICES DURING THE PERIOD 1950-51 TO 1959-60

(1952-53 = 100)

	Money Supply	% Change over Previous Year	Foodgrains Production	% Change over Previous Year	Wholesale Prices	% Change over Previous Year
1949-50	105.7		85.3		101.3	
1950-51	112.2	+ 6.1	89.5	+ 4.9	107.6	+ 6.2
1951-52	102.2	- 8.9	90.1	+ 6.7	114.1	+ 6.0
1952-53	100.0	- 2.2	100.0	+11.0	100.0	-12.4
1953-54	101.7	+ 1.7	117.8	+17.8	101.2	+ 1.2
1954-55	108.8	+ 7.0	113.7	- 3.5	97.4	- 3.8
1955-56	123.8	+13.8	114.0	+ 0.2	92.5	- 5.0
1956-57	131.1	+ 5.9	119.2	+ 4.6	105.3	+13.8
1957-58	135.4	+ 3.3	106.8	-10.4	108.4	+ 2.9
1958-59	141.6	+ 4.6	126.8	+18.7	112.9	+ 4.2
1959-60	153.1	+ 8.1	126.9	+ 0.1	117.1	+ 3.7
1960-61	. .	. .	. .	. .	124.8	+ 6.6

Sources: Reserve Bank of India, Report on Currency and Finance, 1949-50 to 1959-60; Reserve Bank of India Bulletin (July, 1961).

an increasing rate. In fact, during 1953-54 the increase was as high as 17.8 per cent. Then, all of a sudden, presumably because of natural calamities the production fell by 3.5 per cent in the following year and remained almost static during 1955-56, which incidentally was the concluding year of the First Plan.

It may be of interest to observe that on the one hand within the period of the First Plan the production of foodgrains was moving up until the end of 1952-53; on the other, the money supply during this period was declining. For instance, the money supply declined by 8.9 per cent in 1951-52 and again by 2.2 per cent in the following year. Partly as a combined result of these variations wholesale prices declined during 1952-53 by 12.4 per cent.

The first increase in the money supply occurred in 1953-54 when the First Plan began to gather momentum. This upward trend continued in the following years, the money supply increasing during 1954-55 by 7.0 per cent. The increase in the money supply during 1954-55 was accompanied by a fall in the production of foodgrains of 3.5 per cent. Contrary to general expectations, however, wholesale prices declined in the following year (assuming a time lag of one year) by 5.0 per cent. The reason for this may have been an increase in the total availability of foodgrains because of a delay in its flow (that was produced in the year 1953-54) into the market.

In the last year of the First Plan (1955-56) the money supply increased by 13.8 per cent -- the highest increase in any year. The food production, however, remained virtually static in that year with the result that the general price level also went up by 13.8 per cent in the following year (1956-57).

The above analysis is suggestive of the fact that despite the accelerated tempo that started in 1953-54, resulting in a conspicuous increase in the money supply, in the latter part of the First Plan inflationary pressures were kept under control owing, at least partly, to an increase in food production. Put differently, over the First Plan period foodgrains acted as a cushion between an increase in the money supply and a consequent increase in wholesale prices.

As mentioned before, during the Second Plan a more direct relationship between the money supply and wholesale prices was evidenced, although variations in the food production continued to influence the generation of inflationary pressures in the economy.

In the earlier phase of the Second Plan the general trend of money income outpacing food production continued, although in a modified form. There was a slowing down in the rate of increase in the money supply; nevertheless the increase was still 5.9 per cent in 1956-57. During the same year, however, food production increased considerably (4.6 per cent) with the result that the rise in wholesale prices was moderate (2.9 per cent) in the following year. In 1957-58 the situation was different from the previous year. In that year the money supply increased only by 3.3 per cent, while the food production recorded a sharp fall of 10.4 per cent. In consequence the wholesale price index increased by 4.2 per cent in 1958-59 -- the increase in these prices being 0.9 per cent higher than that in the money supply.

That the food production acted as a factor partially controlling the "new" inflation in India was again demonstrated towards the latter part of the Second Plan. During the two years ending March, 1960, the money supply conspicuously increased, the increase in 1958-59 and 1959-60 being 4.6 per cent and 8.1 per cent respectively. Simultaneously, because of a record harvest the food production increased by 18.7 per cent in 1958-59, and a further rise of 0.1 per cent was recorded in the following year. As a combined result of these developments the price level increased (with a time lag) only by 3.7 per cent in 1959-60 and by 6.6 per cent in the following year -- the increase in wholesale prices in each of the two years being lower than the increase in the money supply in the respective preceding years. Following the same line of reasoning it is observed that over the first four years of the Second Plan the money supply increased from 123.8 in 1955-56 to 153.1 in 1959-60, or by 26.7 per cent over the four-year period, while the increase in the food production during the same period was of the order of 11.3 per cent. Consequently, assuming again a time lag of one year, wholesale prices increased by only 18.5 per cent during the four years 1956-57 to 1960-61.

An attempt has been made in the above discussion to show the importance of food production in influencing the course of inflation in India. While it is statistically not possible to demonstrate the full effect of variations in food production alone on the inflation generated by the expansion in the money supply, the above analysis is at least suggestive of the fact that in India during the period of development foodgrains did act as a cushion both in controlling the inflation and also mitigating its pressure.

While the study undertaken above is indicative of the fact that variations in the availability of foodgrains influenced, to a considerable degree, the generation of inflationary pressures in India, the foreign exchange assets that were available for bridging the balance of payments gap may also have been an additional factor influencing the price level in India. An investigation of the role of foreign exchange assets vis-a-vis the "new" inflation generated in India is therefore undertaken below.

In view of the direct relationship that exists between balance of payments and foreign exchange reserves in India, a more detailed discussion of this relationship appears desirable at this point.[1] Generally speaking a surplus in the balance of payments leads to an increase in the foreign exchange reserves (gold and foreign assets) of the Reserve Bank. The Indian exporters who receive foreign exchange reserves deposit them with the commercial banks. These banks in turn present these reserves to the Reserve Bank and obtain credit from the Bank. This adds to the reserves of the commercial banks enabling them to expand their credit and thereby the total money supply. Precisely then, a favorable balance of payments position has the following effects. First, the foreign exchange reserves of the Reserve Bank are increased, which enables it to expand the money supply.[1] In the second place, having obtained reserves from the Reserve Bank, the commercial banks increase their capacity to create credit. And finally, the export surplus drains off goods[2] from the country to the extent of the surplus and therefore reduces the goods available for consumption relative to the total money demand. In short, a favorable balance of payments position, reflected in the net addition to the foreign exchange reserves of the banking system, is almost always expansionary and is often inflationary for the reasons enumerated above.

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[1] For a theoretical discussion see Singh, op. cit., pp. 167-68; also see K. C. Chacko, The Monetary and Fiscal Policy of India (Bombay: Vora and Company, Ltd., 1947), p. 147.

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[1] Until 1956, the Reserve Bank Act prescribed a proportional reserve (of 40 per cent) of gold and foreign securities against note issue. The Reserve Bank of India (Amendment) Act of 1956 provided for substitution of the proportional reserve system by a minimum of foreign reserves in absolute amount, namely Rs. 5,150 million in gold and foreign securities. Even then, it may be observed, the issue requirements remained, although in a less restricted form, tied to the availability of foreign exchange reserves.

[2] An important feature of the balance of payments of underdeveloped countries is that, as a rule, they are capital-goods-importing and consumer-goods-exporting countries. This feature has become all the more important in the postwar period, since most underdeveloped countries have embarked upon intensive development programs necessitating huge imports of capital goods. The total effect of this feature is to further reduce consumption goods in the country.

It is worth mentioning in this context that the relationship between balance of payments and inflation is not so clear and direct as it *prima facie* appears to be. The reason is that an increase in the money supply exerts its pressure on prices through its influence on the aggregate level of income. The effect of the variation in the money supply on the price level is in fact the net result of the working of a host of factors, such as business conditions, stage of production, wage structure, liquidity preference of the people, and so on. Moreover the balance of payments trends can be as much the cause as the effect of price changes in the country. For example, inflationary price trends may increase imports while discouraging exports and thereby have an adverse effect on the balance of payments position of the country.[1]

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[1] This line of thinking is largely influenced by the

While the causal relationship between the balance of payments trend and inflation may not always be clearly established, it is obviously true that a surplus in the payments position, which is expansionary in character, will augment the country's foreign exchange resources. Likewise the reverse will be true when the imports exceed the exports of the country. It is therefore justifiable to conclude that in general a reduction in the foreign exchange reserves of the country is contractionary and vice versa.

The above view needs to be duly qualified in the context of an underdeveloped country. As mentioned above, normally the drawing down of the foreign exchange reserves would have a contractionary effect on the economy. However, contrary to the normal expectation, many underdeveloped countries which import in excess of their exports and thereby draw down their past accumulated foreign exchange reserves experience mounting pressures of inflation. This contra-

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writings of Lord Keynes. According to Keynesians, balance of payments changes affect directly the national income and through it influence the price level. Some economists, however, go further and claim that the balance of payment, which influences the national income, is itself influenced by a host of factors, such as elasticity of demand for imports and the elasticity of supply, increase in productivity, foreign transfers, reparation payments and tariffs, changes in wage, interest, and exchange rates, speculative activity, etc. See J. E. Meade, The Balance of Payments (4th ed. rev.; London: Oxford University Press, 1956), pp. 43-51.

diction may be explained in the following manner. In most of the developing economies, the import surplus, far from being a counteracting force, is a positive factor that helps to intensify the pressure of demand on the inelastic consumer goods. This is because the major portion of imports comprises capital goods rather than consumption goods. The import of capital goods, financed mainly by drawing on the foreign exchange assets, creates a demand for consumption inasmuch as they call for a complementary domestic expenditure, and thus to a great extent intensifies domestic inflationary pressures.

There is another reason why the drawing down of the foreign exchange assets does not reduce in many instances the inflationary pressures generated by the process of development. The reason for this is rather subtle. As underdeveloped countries progress idle money in the economy is activated, the financial sector expanded, and the money supply increased -- all these factors leading to an increase in the income-velocity of money. Moreover, pressed with ever increasing demand for a larger quantity of money supply, governments of these countries may modify the currency laws so as to require the central bank to hold lower reserves for the currency issued. Such an action on the part of the government would broaden the opportunities for increasing the money supply. It is against this background that the role of foreign exchange reserves in India in influencing the new inflation situation should be viewed.

The government of India embarked upon an ambitious development program in April, 1951, which necessitated large-scale importation of capital goods. The determining factor was the foreign exchange reserves already available in the country for bridging the balance of payments gap. During World War II and in the postwar period, India had accumulated a large amount of foreign exchange reserves which was the result of (1) the favorable balance of payments on private account, and (2) the large expenditure incurred in India on account of the UK for war disbursements and also incurred by that country on account of other Allied governments and recoverable from the British government. The foreign exchange reserves available to the government of India on the eve of the First Plan (1950-51) was Rs. 9,514 million. On the strength of these past accumulated reserve balances the government decided that it could successfully finance an average balance of payments deficit of the order of Rs. 1,800-2,000 million per annum over the First Plan. Further, the above annual deficit was expected to increase to about Rs. 3,000 million a year over the Second Plan period. As it turned out, however, except for the year 1951-52 (when there was a large deficit owing to heavy food imports), there was a surplus each year in the balance of payments over the First Plan,as may be seen from Table 42. This Table also reveals that since 1956-57 when the Second Plan was launched, the real impact of the development financing on the Indian balance of payments was observed. The balance of payments deficit, which was Rs. 3,123 million in 1956-57, reached the peak of Rs. 4,270 million in the next year. And although the rate of deficit slowed down in the following years, the deficit was no less than Rs. 1,826 million in 1959-60.

Movements in the foreign exchange assets of the banking system, shown in Table 43, only reiterate this point.

According to Table 43, during the First Plan there was a net decrease of Rs. 958 million in the foreign exchange reserves of the banking sector. If on the other hand the 1951-52 deficit (which was the result of special food imports) is ignored, foreign reserves would appear to have recorded a net increase of Rs. 905 million during the last four years of the Plan. It was explained earlier that as a rule and in general, increase in the foreign exchange reserves is

TABLE 42

INDIA'S BALANCE OF PAYMENTS DURING THE PERIOD 1950-51 TO 1959-60

(Current Account)

Million Rupees

Year	Imports c.i.f.	Exports f.o.b.	Trade Balance
1950-51	6,503	6,468	- 35
1951-52	9,629	7,301	-2,328
1952-53	6,330	6,019	- 311
1953-54	5,918	5,397	- 521
1954-55	6,838	5,966	- 872
1955-56	7,506	6,411	-1,095
1956-57	10,995	6,352	-4,643
1957-58	12,336	6,685	-5,651
1958-59	10,296	5,759	-4,537
1959-60	9,245	6,232	-3,013

Sources: Reserve Bank of India, India's Balance of Payments, 1948-49 to 1955-56; Reserve Bank of India, Report on Currency and Finance, 1956-57 to 1960-61.

[a] Official Donations represent contra entries financed by aid received under the Colombo Plan, Indo-American Technical Cooperation Agreement, and cash receipts from the Ford Foundation.

TABLE 42 -- Continued

Official Donations[a]	Other Invisibles (net)	Total Current Transactions (net)
+ 21	+ 403	+ 389
+ 53	+ 649	-1,626
+108	+ 805	+ 602
+190	+ 805	+ 474
+158	+ 774	+ 60
+420	+ 844	+ 169
+395	+1,125	-3,123
+341	+1,040	-4,270
+344	+ 917	-3,276
+371	+ 816	-1,826

TABLE 43

VARIATIONS IN THE NET FOREIGN EXCHANGE ASSETS OF THE BANKING SECTOR DURING THE PERIOD 1951-52 TO 1959-60

Million Rupees

Year	Variations in Net Foreign Exchange Assets of Reserve Bank	Variations in Net Foreign Exchange Assets of Banks	Variations in Net Foreign Exchange Assets of Banking Sector
1951-52	-1,611	-252	-1,863
1952-53	+ 6	+321	+ 327
1953-54	+ 464	+ 15	+ 479
1954-55	- 56	- 16	- 40
1955-56	+ 233	- 94	+ 139
1951-52 to 1955-56 Total	- 964	+ 6	- 958
1956-57	-2,773	+156	-2,617
1957-58	-2,948	+126	-2,822
1958-59	- 561	- 36	- 597
1959-60	+ 56	- 29	+ 27
1956-57 to 1959-60 Total	-6,226	+217	-6,009

Source: Reserve Bank of India Bulletin (July, 1961), p. 1065.

expansionary. The increase in the foreign reserves during the above period was accompanied by a rise in the money supply (of 21.1 per cent). However, contrary to the normal expectation, the wholesale price level declined by 18.9 per cent. The reason for this may have been, as explained earlier, the increased availability of foodgrains which partially offset the expansionary effect of the increased money supply.

Economic conditions during the first four years of the Second Plan were very different from those prevailing during the First Plan. With the progress of the Second Plan the country experienced rapid depletion of its foreign reserve balances; during the period 1956-57 and 1959-60, these reserves declined by Rs. 6,009 million. While this rapid depletion of reserves would normally be expected to exert a contractionary effect on the economy, there was in fact generation of mounting pressures of inflation in the Indian economy. It is perhaps not possible to establish the causal relationship between variations in the foreign assets and the price level. Nevertheless an attempt may be made to single out certain developments which were presumably responsible for partially offsetting the contractionary effects of the depletion of the reserves.

The first development relates to the amendment of the Reserve Bank Act in 1956. By this amendment the proportional reserve system of note issue was changed to the fixed reserve system. Until 1956 India was on a proportional reserve system of note issue which implied that the Reserve Bank was obliged by law to curtail its note issue if the foreign assets declined below the required level (that is, 40 per cent of the total note issue). This was precisely the case at the end of the First Plan. The ratio of foreign exchange reserves to note issue conspicuously dropped from 71.0 per cent at the end of 1950-51 to 54.8 per cent at the end of 1955-56, and was expected to drop further as the pace of development was further accelerated. Confronted with the problem of rapidly declining foreign exchange assets, the Reserve Bank decided to urge the amendment of the Reserve Bank Act in May, 1956. The duly amended Act prescribed for the maintenance of a fixed foreign asset balance of only Rs. 4,000 million. The 1956 Act was further amended in 1957, which lowered the required foreign reserves to Rs. 850 million. These amendments paved the way for the large-scale monetary expansion and thereby acted in subsequent years as a factor partially offsetting the contractionary effect of the declining foreign reserves.

Another factor which was responsible for an appreciable monetary expansion in the economy was the large-scale deficit financing planned and resorted to by the government during the Second Plan period,[1] as is evident from Table 44. It is at once evident that the amount of deficit financing over the first four years of the Second Plan (Rs. 10,120 million) was much larger than the first four years of the First Plan (Rs. 2,401 million). It may also be noted that the average deficit financing on an annual basis was also much higher during the Second Plan (Rs. 2,530 million) as compared to the average deficit financing during the First Plan (Rs. 1,330 million).

Variations in the magnitude of deficit financing in reference to the total outlay on the Second Plan also reveal some interesting facts. During the year 1957-58 the amount of deficit financing was Rs. 4,960 million, which was 56.2 per cent of the total outlay on the Second Plan during that year. This ratio of deficit financing to the total Plan outlay was highest over the entire period under study. Over the first four years of the Second Plan

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[1] Deficit financing is used here in the "Indian" sense. In this chapter and in chapters VIII and IX, the concept of "Indian deficit financing" will be consistently used.

TABLE 44

PLAN OUTLAYS AND THEIR FINANCING DURING THE PERIOD 1951-52 TO 1959-60

Million Rupees

	1951-52	1952-53	1953-54	1954-55	1955-56
Outlay on the Plan	2,594	2,676	3,430	4,759	6,665
Budgetary resources[a]	2,048	1,413	2,461	3,686	3,165
External assistance	649	456	185	160	582
Total resources	2,697	1,869	2,646	3,846	3,747
Deficit financing	-103	807	784	913	2,918
Aggregate resources/ Plan outlay	2,594	2,676	3,430	4,759	6,665

Sources: Government of India, Review of the First Five Year Plan, May, 1957, p. 23; Reserve Bank of India, Report on Currency and Finance, 1959-60, p. 63.

[a] Budgetary resources consist of: (1) balance from current revenues (without taking into account additional taxation), (2) additional taxation, (3) railways' contributions, (4) loans from the public, (5) small savings, and (6) unfunded debt and miscellaneous capital receipts.

TABLE 44 -- Continued

Total for First Plan	1956-57	1957-58	1958-59	1959-60	1956-57 to 1959-60
20,124	6,340	8,820	9,980	10,060	35,200
12,773	3,390	2,910	6,450	6,090	18,840
2,032	420	950	2,170	2,700	6,240
14,805	3,810	3,860	8,620	8,790	25,080
5,319	2,530	4,960	1,360	1,270	10,120
20,124	6,340	8,820	9,980	10,060	35,200

(1956-57 to 1959-60) the total outlay on the Plan amounted to Rs. 35,200 million; the contribution of deficit financing was Rs. 10,120 million, or 28.8 per cent of the total outlay. As has been pointed out in chapter VI, deficit financing is in general always expansionary. It is conceivable, therefore, that such a large magnitude of deficit financing also partially offset the contractionary effect of the falling foreign reserve balances.

A third factor that may also have moderated, albeit to a very limited degree, the effects of the declining foreign assets was the more intensive utilization of the money income as may be seen from Table 45. Table 45 indicates that the income velocity of money slightly increased from 4.8 per cent in 1955-56 to 5.0 per cent in 1958-59 (except for 1957-58 when the velocity was 4.8 per cent). And although the ratio declined in 1959-60 to 4.8 per cent it was nevertheless no less than the income velocity at the end of the First Plan (1955-56).

The above discussion only suggests that certain forces operated within the economy during the two Plan periods which might have, to a certain degree, offset the effects of the variations in the foreign reserve balances of the country. Also, speaking specifically of the "new"

TABLE 45

INCOME VELOCITY OF MONEY IN INDIA DURING THE PERIOD 1949-50 TO 1959-60

Year	Nat'l Income at Current Prices	Money Supply	Ratio of Nat'l Income to Money Supply
	Million Rupees	Million Rupees	%
1949-50	90,100	18,607	4.8
1950-51	95,300	19,795	4.8
1951-52	99,700	18,038	5.5
1952-53	98,200	17,647	5.6
1953-54	104,800	17,940	5.8
1954-55	96,100	19,206	5.0
1955-56	99,800	21,843	4.8
1956-57	113,100	23,129	4.9
1957-58	113,900	23,888	4.8
1958-59	126,000	24,988	5.0
1959-60	128,400	27,010	4.8

Sources: Reserve Bank of India, Report on Currency and Finance, 1949-50 through 1959-60; Reserve Bank of India Bulletin, Statement 58A (May, 1961), p. 829.

Note: Income-velocity of money is measured by the ratio of national income at current prices to the money supply.

inflation generated in the economy during the Second Plan, it might be appropriate to conclude that the falling reserve balances did have a contractionary effect on the economy, which was more than offset by the various strong expansionary forces that were operating in the economy over the four years of the Second Plan.

To sum up, in India, in the earlier phases of development, despite the acceleration of the development tempo, no appreciable inflationary pressure was generated and, over the First Plan period, prices were in fact down by 14.0 per cent. The reason perhaps was that a cushion in the form of surplus food supply was available which kept the inflationary pressure under control. In the Second Plan period, the deficit financing was accelerated. Simultaneously the government began large-scale importation of capital goods, leading to a sizable balance of payments deficit. As a result, there was a massive reduction in foreign exchange assets, and a substantial increase in the money supply. While these factors produced pronounced inflationary effects, an increase in the food supply during the latter part of the period somewhat eased the inflationary pressure.

If the above thesis is accepted, it would appear that the inflation that was generated in the economy as a result of the accelerated pace of development could be curtailed or controlled, or at least mitigated, either by the stepping up of the food supply or by reducing the total quantum of credit. The former, it may be observed, was primarily dependent upon natural causes, such as good rain, absence of droughts, larger imports, etc., and was therefore outside the scope of the monetary authorities. On the other hand, reducing the total volume of credit was hardly feasible without slowing down the pace of development.

It follows therefore that if the government of a country determines the rate of investment in advance and then undertakes to finance such investment by the method of deficit financing, they do in fact subordinate the monetary policy to fiscal policy. In that case, the monetary authorities are left with no other choice but to control the inflationary pressures generated by deficit financing _as best as is feasible_.

It is important to recall that inflation can be controlled either by reducing the monetary demand or by increasing production. While it is the former area only within which monetary authorities operate, stepping up of production either by increasing the domestic production or with the help of imports can, at least theoretically, also mitigate inflation and therefore has significant monetary implications. As mentioned earlier, the major expenditure of the general mass in India is on food articles; consequently increasing the food supply considerably mitigates inflationary pressures in the country. In this connection the importation of foodgrain under American Public Law (P.L.) 480[1] deserves special mention.

In terms of P.L. 480 the governments of the United States and India entered into four Agricultural Commodities Agreements (the first in August, 1956, and the latest in November, 1959) for the purchase by the latter of wheat, rice, corn, milo, and cotton, and, under the first agreement, some tobacco and dairy products, their aggregate landed costs being estimated at Rs. 4,270 million.[2] Arrangements under this law were different from either outright purchases of the above-mentioned commodities from a foreign country, or the receipt of food gifts from friendly nations. The US government agreed to pay 50 per cent of the ocean freight and return a part (Rs. 880 million) of the payments to India as "grants." The balance of the payments were to be made in Indian rupees to the TCM, New Delhi, which were to be held, until required, on fixed deposit with the State Bank of India. Obviously this arrangement was designed to relieve the foreign exchange pressure on India. The TCM deposits with the State Bank of India were meant to be used partly toward the expenditure of the US Embassy in India (Rs. 700 million), partly for loans to US and Indian firms (Rs. 410 million) and especially for loans to the government of India to finance projects of economic development (Rs. 2,280 million). Though until the close of 1959, Rs. 1,540 million were reloaned to the government of India, the amounts actually disbursed were much smaller, with the result that considerable uncommitted funds remained with the TCM.

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[1] Public Law 480, "Agricultural Trade Development and Assistance Act of 1954," published in U. S. Statutes at Large, Vol. 68, Part I, Public Laws Reorganization Plans, pp. 454-59, reads: "The Act is designed to 'expand international trade among the United States and friendly nations, to facilitate the convertibility of currency, to promote the economic stability of American agriculture and the national welfare, to make maximum efficient use of surplus agricultural commodities in furtherance of the foreign policy of the United States, and to stimulate and facilitate the expansion of foreign trade in agricultural commodities produced in the United States by providing a means whereby surplus agricultural commodities may be sold through private trade channels and foreign currencies accepted in payment therefor.'"

[2] Times of India, January 28, 1960.

The aid under P.L. 480 has to be viewed against the developments that took place in India in the area of foodgrains. With the rise of inflationary pressure in

1955-56, foodgrains prices began to increase rapidly, necessitating more imports to meet the swollen demand. Imports of foodgrains in 1956 doubled to 1.42 million tons. In 1957, mainly as a P.L. 480 aid, imports went up to 3.6 million tons. Imports of over three million tons a year continued in 1958 and 1959, in the latter year despite a record harvest of 73.5 million tons -- a rise of 21 per cent in a year.

Recent investigations suggested that as India's imports of foodgrains increased chiefly due to the special US program, inventory accumulations also increased induced by continuously rising prices; and it may well be that "during the preceding two years . . . imports were balanced by additions to inventories."[1] The Asoka Mehta Committee noted that larger firms resorted to inventory accumulations in 1956-57, thus raising prices of foodgrains.[2] In addition, the findings of an "agro-economic" survey in several parts of the country, conducted by the Ministry of Food and Agriculture,[3] were also similar to the findings of the Mehta Committee.

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[1] B. R. Shenoy, "Aid under P.L. 480," Times of India, January 28, 1960.

[2] See Commerce, June 11, 1960, p. 1034.

[3] Foodgrains Inquiry Committee established in 1957 was one of them. See Commerce, March 26, 1960, p. 534.

To conclude, the P.L. 480 aid resulted in an increase in the availability of foodgrains in the country. Simultaneously, however, there developed speculative activities in the foodgrains market resulting in the hoarding of this commodity and thereby reducing its total supply in the market. It is pertinent to mention here that there is little possibility of predicting if these shortages would have been caused even in the absence of the P.L. 480 aid. Nevertheless the above analysis does suggest that, because of the possibilities of speculation and hoarding, even foreign aid in the form of import of foodgrains in extremely easy and favorable payment terms may not improve the economic situation in the country. The only alternative to control the monetary inflation under these circumstances would appear to be the curtailment of the monetary demand.

The Reserve Bank and the New Inflation

Our analysis throws one point into bold relief: the large expansion in the money supply was primarily responsible for the "new" inflation generated in the Indian economy during the period of time devoted to the development planning.[1] In this connection percentage changes in the national income and the money supply during the two Plan periods, shown in Table 46, are illuminating. The Table shows that during the First Plan the rate of increase in the money supply (10.4 per cent) was lower than the rate of increase in the national income (at constant prices) which was 18.4 per cent. This was, as mentioned before, primarily because the food supply acted as the cushion to the inflationary pressures that would otherwise have been generated in the economy during the First Plan. Put differently, the economic gains (in terms of national income) were achieved at an annual rate of 3.5 per cent a year, which was much higher than the average rate of increase in the money supply (2.0 per cent) during the same period.

The situation was different in the four years following the First Plan. During the period 1955-56 to 1959-60 the money supply increased by as much as 28.0 per cent, or at an annual average rate of 6.3 per cent

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[1] It is recognized that statistically it is difficult to prove that the inflation was solely due to the expansion in the money supply. However, the analysis provided by us has suggested a great possibility for the existence of such a relationship.

TABLE 46

PERCENTAGE CHANGE IN NATIONAL INCOME AND MONEY SUPPLY DURING THE PERIOD 1951-52 TO 1959-60

Per Cent Per Annum

	National Income		Money Supply
	At Constant Prices	At Current Prices	
First Plan 1951-52 to 1955-56	18.4	4.7	10.4
Second Plan (4 yrs.) 1956-57 to 1959-60	12.2	28.7	28.0
Average annual rate of increase during First Plan 1951-52 to 1955-56	3.5	0.9	2.0
Second Plan (4 yrs.) 1956-57 to 1959-60	2.9	6.5	6.3
Two plans (9 yrs.) 1951-52 to 1959-60	3.3	3.4	3.5

Sources: Reserve Bank of India, Report on Currency and Finance, 1951-52 to 1959-60; Reserve Bank of India Bulletin, Statement 58A (May, 1961), p. 829.

compounded. Partly as a result of the accelerated rise in the money supply the increase in the money income during this period (28.7 per cent) far outweighed the increase in the national income at constant prices (12.2 per cent), the latter being at an average annual rate of only 2.9 per cent, compounded. Over the nine-year Plan period (1950-51 to 1959-60) the money supply increased at an average rate of 3.5 per cent, the national income (at current prices) by 3.4 per cent, and the national income (at constant prices) by 3.3 per cent.

Since this is a study of the role of the Reserve Bank vis-a-vis developmental planning in India it seems more desirable to analyze the variations in the money supply specifically over the Plan period of nine years. A conclusion can then be drawn as to how far the Bank was directly responsible for the inflation that was generated in the process of development.

Table 47 provides a detailed breakdown of the variations in the money supply and the factors affecting such variations. It may be observed from the Table that during the First Plan period (1950-51 to 1955-56) the total increase in the money supply was Rs. 1,987 million; there was a substantial decline in the first two years, after which

TABLE 47

ANALYSIS OF MONEY SUPPLY VARIATIONS DURING THE PERIOD 1951-52 TO 1959-60

	Outstanding Mar.30,1951	1951-52	1952-53
Money supply with public[a](1+2+3)	19,757	-1,794	-438
1. Currency with public	13,290	-1,193	-227
2. Other deposits with Reserve Bank	260	- 64	- 31
3. Bank money	6,207	- 537	-180
FACTORS AFFECTING MONEY SUPPLY VARIATIONS			
1. Net bank credit to govt.(a+d+e)	9,731	- 659	+419
a) Reserve Bank's net credit to govt.(b-c)	4,605	- 263	+491
b) Aggregate variations in Reserve Bank's fin.assets (incl. rupee coins)	6,489	- 95	- 5
c) Variations in govt. deposits with Reserve Bank	1,884	+ 168	-496
d) Bank's credit to govt.	3,470	- 249	+ 89
e) Govt.'s net currency liability to public	1,656	- 147	-161
2. Net bank credit to private sector(a+b)	2,867	+ 651	-765
a) Reserve Bank's credit to private sector(a+b)	12	+ 1	+ 2
b) Bank's net credit to private sector (c-d)	2,855	+ 650	-767
c) Variations in banks' fin. assets	6,191	+ 562	-409
d) Variations in non-monetary liabilities of banks	3,336	- 88	+358

Source: *Reserve Bank of India Bulletin*, Table 1 (July, 1961) pp. 1058-59.

[a] Differs from figures in Reserve Bank *Report on Currency and Finance* because of slightly "modified definition" of money supply. For details, see S. L. N. Simha (*et al.*) "Analysis of Money Supply in India," *Reserve Bank of India Bulletin* (July, 1961), pp. 1045-67.

TABLE 47 -- Continued

1953-54	1954-55	1955-56	1951-52 to 1955-56	Outstanding Mar.30,1956
+251	+1,326	+2,643	+1,987	21,844
+260	+ 883	+1,939	+1,662	15,052
- 18	- 50	+ 23	- 140	120
+ 9	+ 493	+ 681	+ 465	6,672
-326	+1,070	+1,948	+2,452	12,282
-234	+ 822	+1,646	+2,462	7,067
-507	+ 736	+1,743	+1,872	8,361
-273	- 86	+ 97	- 590	1,294
+181	+ 281	+ 212	+ 514	3,983
-273	- 33	+ 90	- 524	1,232
- 10	+ 230	+ 954	+1,060	3,928
+ 33	- - -	+ 12	+ 48	61
- 43	+ 230	+ 942	+1,012	3,867
+121	+ 747	+1,368	+2,389	8,579
+164	+ 517	+ 426	+1,377	4,712

TABLE 47 -- Continued

	Outstanding Mar.30,1956	1956-57	1957-58
Money supply with public[a] (1+2+3)	21,844	+1,239	+ 771
1. Currency with public	15,052	+ 518	+ 513
2. Other deposits with Reserve Bank	120	- 4	+ 82
3. Bank money	6,672	+ 775	+ 176
FACTORS AFFECTING MONEY SUPPLY VARIATIONS			
1. Net bank credit to govt.(a+d+e)	12,282	+3,096	+5,020
a) Reserve Bank's net credit to govt.(b-c)	7,067	+3,309	+4,212
b) Aggregate variations in Reserve Bank's fin. assets (incl. rupee coins)	8,361	+2,981	+4,279
c) Variations in govt. deposits with Reserve Bank	1,294	- 328	+ 67
d) Bank's credit to govt.	3,983	- 118	+ 806
e) Govt.'s net currency liability to public	1,232	- 95	+ 2
2. Net bank credit to private sector(a+b)	3,928	+1,034	-1,467
a) Reserve Bank's credit to private sector(a+b)	61	+ 5	- 7
b) Bank's net credit to private sector (c-d)	3,867	+1,029	-1,460
c) Variations in banks' fin. assets	8,579	+1,655	+ 915
d) Variations in non-monetary liabilities of banks	4,712	+ 626	+2,375

TABLE 47 -- Continued

1958-59	1959-60	1955-56 to 1959-60	Outstanding Mar. 30, 1960
+1,100	+2,049	+5,209	27,002
+1,180	+1,387	+3,598	18,598
- 6	+ 25	+ 97	219
- 74	+ 636	+1,513	8,185
+3,325	+2,639	+14,080	26,311
+1,564	+1,455	+10,540	17,607
+1,338	+1,711	+10,309	18,669
- 226	+ 256	- 231	1,062
+1,744	+1,035	+3,467	7,450
+ 17	+ 149	+ 73	1,254
-1,415	- 599	-2,447	1,481
+ 22	+ 4	+ 24	87
-1,437	- 603	-2,471	1,395
+ 522	+1,544	+4,636	13,214
+1,959	+2,147	+7,107	11,819

there was a progressive increase, the rise in the last year (1955-56) alone being Rs. 2,643 million. The net bank credit to the government sector accounted for an increase of Rs. 2,452 million, while the net bank credit to private sector pushed the money supply up by Rs. 1,060 million. It is of definite interest to note that during this period the Reserve Bank's net credit to the government (Rs. 2,462 million) exceeded the net amount of credit supplied to the government by the entire banking sector.

During the first four years of the Second Plan period (1955-56 to 1959-60) the total increase in the money supply was Rs. 7,224 million. The expansion took place during all the four years, the largest rise of Rs. 2,049 million being in the last year (1959-60). The government sector (that is, net bank credit to the government) accounted for an increase of Rs. 14,080 million, while the private sector (that is, net bank credit to the private sector) actually accounted for a decrease of Rs. 2,447 million. Once again the Reserve Bank's net credit to the government was conspicuous, amounting to Rs. 10,540 million, or 74.9 per cent of the total credit by banks to the government. Moreover the Reserve Bank supplied Rs. 24 million to the private sector, when the net credit by banks to the private sector had actually declined by Rs. 2,471 million.

It is thus evident that during the nine-year period now under observation, which coincided with the First Plan and the four years of the Second Plan, the money supply recorded a substantial increase. The increase was much more conspicuous during the Second Plan, when the pace of development was accelerated and the government embarked on massive deficit financing programs. The Reserve Bank was the principal supplier of credit to the government and was therefore the primary generator of monetary expansion in the Indian economy as an instrument of deliberate government policy.

It was observed earlier that if the government of a country deliberately resorts to the method of deficit financing in order to maintain or accelerate the rate of development, and thereby subordinates the monetary policy to fiscal policy, the central bank has no choice but to act as the credit creating machine for the government. However, the central bank still assumes the responsibility of controlling the resultant inflation by pursuing appropriate monetary policy.

It appears from the analysis that was undertaken above that such was the case in India during the period under study. The government of India set the predetermined goals of economic development and then embarked upon development plans the sizes of which were disproportionately large in relation to the available resources in the country. The government was then compelled to resort to deficit financing, at first slowly, and then on a much larger scale. The Reserve Bank was called upon to help the government in the successful implementation of the Five Year Plans. This meant that the Bank had no other alternative but to open the monetary tap so as to make the central banking policy consistent with the total economic policy of the country. This led to pronounced inflationary results.

In the earlier paragraphs the cause of the widespread inflation that was generated in the Indian economy and the agency responsible for it were determined. An attempt may now be made to analyze how successful the monetary authorities were in controlling the "new" inflation, once it was generated and on which the monetary authorities had little control. To this study we now turn.

Monetary Policy Vis-A-Vis New Inflation

An evaluation of the efficacy of the instruments of credit control used by the Reserve Bank may now be attempted.[1] Early in the period under study the Reserve Bank initiated a "new monetary policy." In November, 1951, the Bank raised its rate by a conventional 0.5 per cent to 3.5 per cent. Simultaneously, with a view to making the rate more effective the Bank announced that except in special circumstances it would refrain from buying government securities to meet the seasonal requirements of scheduled banks. Finally, as an integral part of the new policy the Bill Market Scheme[2] was introduced for the first time in January, 1952.

The period immediately preceding the initiation of the new monetary policy was characterized by the presence of two opposing forces: while on the one hand, the general price level was declining, on the other, bank credit and money supply were rising to unprecedented levels.[3] The general price level, which had been rising following the Korean boom, received a setback due to several factors.[1] The general index of wholesale prices given in Table 48 declined from 119.3 in April, 1951, to 113.4 in December, 1951, or a total of 4.9 per cent.

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[1] A factual account of the use of the monetary instruments was given in chapter V.

[2] The Bill Market Scheme has been discussed in chapter III.

[3] Unless otherwise stated the sources of all data used in the section are: Reserve Bank of India, Report on Currency and Finance and Trend and Progress of Banking in India.

In contrast to general prices the bank credit and the money supply were rising during this period, as revealed in Table 49. For instance, during the busy season of 1950-51, scheduled bank credit touched the peak of Rs. 5,680 million, the seasonal expansion having reached the record level of Rs. 1,634 million. The concern on the part of banks to unload their securities to meet the increased demand for funds brought about a steep fall in the prices of short-term securities.[2] Thus, the call money rate increased from 0.58 per cent in 1950 to 0.98 per cent in 1951, while the government bond yield rose

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[1] Some of the factors responsible for the decline in prices were: (1) a break in the prices of certain international commodities following the moderation in the stock-piling program in the USA, (2) a rise in the volume of India's imports owing partly to the more liberal import policy pursued and the freer flow of goods following the Indo-Pakistani interim trade agreement, (3) a rise in both industrial and agricultural production, and (4) a small budgetary surplus.

[2] For details regarding prices, yields and maturities of securities, see Reserve Bank of India, Reports of the Central Board of Directors for the Years ending June, 1950, and 1951.

TABLE 48

INDEX OF WHOLESALE PRICES DURING THE PERIOD 1951-52 to 1959-60

(1952-53 = 100)

End of	1951	1952	1953	1954
Jan.		112.5	100.0	104.9
Feb.		106.9	100.6	102.9
Mar.	113.6	99.2	101.0	104.1
Apr.	119.3	99.0	102.2	105.6
May	120.2	95.8	105.7	102.4
June	118.6	99.9	106.4	99.3
July	117.0	100.6	107.5	99.8
Aug.	113.3	102.1	107.1	101.0
Sept.	114.6	101.8	104.6	100.8
Oct.	114.5	101.9	103.4	99.5
Nov.	113.9	99.2	102.0	97.5
Dec.	113.4	98.3	103.0	96.3

Source: Reserve Bank of India, Report on Currency and and Finance, 1951-52 through 1959-60.

Note: The base for the indices of wholesale prices for March, 1951, through March, 1957, has been converted from August, 1939, to the year 1952-53.

TABLE 48 -- Continued

1955	1956	1957	1958	1959	1960
94.5	98.8	111.7	105.6	113.7	119.2
94.1	100.1	110.7	105.0	112.0	119.4
91.7	102.4	110.4	106.1	111.7	118.6
89.6	102.4	107.2	107.7	111.6	
89.5	102.6	110.3	109.0	114.6	
90.4	105.5	110.6	113.3	115.6	
93.7	108.2	112.4	115.9	116.9	
93.8	110.5	110.9	116.3	116.6	
92.1	109.9	108.7	116.1	118.0	
94.7	109.4	108.9	116.0	118.8	
95.8	113.9	108.6	112.5	117.6	
98.0	110.7	106.3	110.8	117.6	

TABLE 49

VARIATIONS IN BANK CREDIT AND MONEY SUPPLY WITH PUBLIC DURING BUSY AND SLACK SEASONS FOR THE PERIOD 1950-51 TO 1959-60

Million Rupees

Years	Money Supply	Bank Credit
1950-51 S	- 906	- 744
1950-51 B	+2,369	+1,634
1951-52 S	-1,896	- 721
1951-52 B	+ 89	+ 723
1952-53 S	-1,204	-1,048
1952-53 B	+ 882	+ 672
1953-54 S	-1,113	- 763
1953-54 B	+1,492	+1,055
1954-55 S	- 514	- 492
1954-55 B	+1,934	+ 982
1955-56 S	+ 101	- 316
1955-56 B	+2,499	+1,645
1956-57 S	-1,051	+ 37
1956-57 B	+2,394	+1,484
1957-58 S	- 827	- 419
1957-58 B	+1,673	+ 894
1958-59 S	-1,569	-1,179
1958-59 B	+2,910	+1,817
1959-60 S	-1,106	- 790
1959-60 B	+2,772	+1,886

Source: Reserve Bank of India, Report on Currency and Finance, 1950-51 through 1959-60.

Note: S - Slack Season B - Busy Season

from 3.11 to 3.28 per cent over the same period.

The liberal open-market policy of the Reserve Bank together with a sizable increase in bank credit had a direct impact on the money supply. In 1950, due primarily to unloading of government securities by banks and a sizable balance of payments surplus, the money supply had increased by Rs. 600 million. In 1951, on the other hand, owing to the contractionary effect of the heavy balance of payments deficit and the growing cash balances of the central government (reflecting the sale proceeds of the American Wheat Loan and higher revenue receipts), the impact of a huge expansion in the bank credit was considerably mitigated, resulting in a decline in the money supply of Rs. 590 million. Nevertheless the 1950-51 busy season expansion in the money supply was as large as Rs. 2,369 million. Further the contraction in bank credit during the slack season of 1952-52 was less than the usual contraction; this also reflected the existing demand for funds. Consequently the commercial banks entered the busy season of 1951-52 with an overextended position.

With the advent of the busy season towards the end of 1951 the monetary authorities were confronted with three major problems. "Foremost among these . . . was the urgency to prevent further excessive expansion of bank credit without affecting production and legitimate needs of trade and industry; the second was to institute a measure of credit control . . .; and the third was to introduce an element of credit elasticity in the money market."[1] (Italics supplied.)

This, then, was the background against which the Reserve Bank initiated the "new" monetary policy. The immediate impact of the revised policy on the economy was both direct and profound, especially because the "shift" in the policy was brought about at the advent of the busy season which coincides in India with the expansion phase of the market. Immediately following the Bank rate increase banks adjusted their lending and borrowing rates upward.[2] It was also reported that banks in general began to follow a cautious lending policy discouraging the borrowers who were likely to utilize bank funds for hoarding purposes.

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[1] Reserve Bank of India, Trend and Progress of Banking in India, 1951, p. 4.

[2] The State Bank (formerly Imperial Bank) raised its call loan rate on advances of Rs. 500,000 and over to scheduled banks from 2-3/4 to 3 per cent and a month later, in two stages of 1/4 per cent each, to 3-1/2 per cent. The exchange banks, which had raised their lending rates by 1/2 to 1 per cent in July, 1951, increased these rates further by another 1/2 per cent. Other banks also raised their rates generally by about 1/4 to 1/2 per cent. Inter-bank call money rate quoted by the larger banks hardened immediately by 1/4 per cent to 3/4 per cent and, with the progress of the busy season, to 2-1/4 per cent.

The impact of the revised policy on bank credit and the money supply was even more pronounced. Scheduled bank credit which had contracted by Rs. 721 million in the 1951-52 slack season rose by only Rs. 723 million in the following (1951-52) busy season. This increase was of a much smaller magnitude than the previous (1950-51) busy season expansion of Rs. 1,634 million. Also, at the end of June, 1952, scheduled bank credit was standing at Rs. 5,402 million, which was below the level of bank credit (Rs. 5,504 million) reached a year earlier. The seasonal trend in the money supply also followed a similar pattern. During the busy season of 1951-52 the money supply increased by no more than Rs. 89 million, while in the following slack season (of 1952-53) the decline in the money supply was as heavy as Rs. 1,204 million. This compared very favorably with the changes in the money supply during the two previous seasons. There was an increase of Rs. 2,369 million in money supply in the 1950-51 busy season and a decline of Rs. 1,896 million in the following (1951-52) slack season.

The attempt by the Reserve Bank to "unpeg" the government bond market had also pronounced effects. There

TABLE 50

SCHEDULED BANK CREDIT DURING THE PERIOD 1951-52 TO 1959-60

Million Rupees

End of	1951	1952	1953	1954	1955
Jan.		5,793	5,071	5,161	5,775
Feb.		5,924	5,218	5,310	6,074
Mar.		5,927	5,412	5,476	6,342
April	5,736	5,765	5,421	5,737	6,241
May	5,708	5,552	5,456	5,855	6,197
June	5,504	5,402	5,270	5,658	6,098
July	5,341	5,180	5,080	5,510	6,009
Aug.	5,167	4,972	4,901	5,382	6,062
Sept.	4,981	4,879	4,778	5,395	5,929
Oct.	4,998	4,759	4,703	5,414	5,925
Nov.	5,176	4,700	4,674	5,389	5,941
Dec.	5,545	4,850	4,738	5,543	6,356

Source: Reserve Bank of India, Report on Currency and Finance, 1951-52 to 1959-60.

TABLE 50 -- Continued

1956	1957	1958	1959	1960
6,757	8,265	9,081	9,210	10,198
6,971	8,568	9,307	9,590	10,609
7,612	9,000	9,627	10,136	11,279
7,570	9,091	9,566	10,204	
7,690	9,329	9,235	10,119	
7,569	9,178	9,028	9,852	
7,402	8,861	8,861	9,568	
7,350	8,525	8,566	9,371	
7,545	8,466	8,412	9,204	
7,607	8,672	8,387	9,415	
7,665	8,400	8,327	9,230	
7,884	8,571	8,656	9,645	

was a sharp fall in the prices of government bonds. The Reserve Bank's index number of Government of India securities declined between November 10, 1951, and December 1, 1951, by approximately 6 per cent.

Reflecting restrictive credit conditions, the general price level also declined. The index number of wholesale prices sharply declined from 113.9 in November, 1951, to 95.8 in May, 1952, a fall of 15.9 per cent. Further, the fall in the prices of industrial raw materials, which were the main object of speculative interest, was much more conspicuous during this period than the fall in the prices of foodgrains and semi-manufactured articles.

It would be erroneous to conclude from the above downtrend in the selected indicators, as did an official report, that "the new monetary policy secured the objectives of preventing a large expansion of money supply during the busy season, and of enabling the Bank to have a more effective control on the magnitude and purpose of bank loans."[1] For although an increase in the Bank rate and the unpegging of the bond market did have an immediate effect subsequent developments did not fully follow the downward adjustment of the monetary indicators referred to above. For instance, during the 1951-52 busy season the level of scheduled bank credit touched the peak of Rs. 5,997 million, which was higher than the highest level reached in the corresponding period of the previous busy season. Further, on March 21, 1952, the advances-deposits ratio increased to 70.4 per cent, in contrast to the highest figure of 64.8 per cent in the previous busy season. Moreover, there was no evidence to the effect that, despite dear money conditions, stocks with the industries were low; in fact, in maintaining high stocks they were helped, at least in part, by the decline in the raw material prices that followed the Bank rate increase. Besides, even in the investment market, notwithstanding dear money conditions, activity was reported to be greater in 1952 than in 1951. For instance, the effective rate for 12-year government loans ruled over 4 per cent, while many municipalities, corporations, and private houses placed sizable issues, although at rates as high as 7.5 per cent. Finally, small savings did not fall very much below the levels in the corresponding period of the previous year; the net amount collected by way of small savings was Rs. 300 million for the nine months ending August, 1952, as against Rs. 340

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[1] Reserve Bank of India, Report of the Central Board of Directors for the Year Ending June, 1952, p. 19.

million in the corresponding nine months of the previous year.

It was mentioned above that there was an immediate impact of the revised monetary policy on the economy. However, it is not fully justifiable to attribute the favorable changes that were observed in the economy to the monetary measures alone; for the total economic policy consisted of non-monetary measures as well, which were designed to achieve the same objectives. For instance, during 1951-52 there was a substantial revenue surplus in the budget of the government of India, as may be seen from Table 51. This surplus together with the sale proceeds of the US Wheat Loan enabled the government to meet the financial requirements in connection with the economic development in the country without drawing from their cash balances. Moreover, the contractionary effect of the modification of the stockpiling program in the USA on the Indian economy may have been significant. In view of these factors it is more apt to conclude that "in the downtrend in price level which commenced in the latter part of 1951, external factors, such as modification of the stockpiling programme in the USA and fall in external demand for many of . . . export products, played a signi-

TABLE 51

BUDGETARY POSITION OF THE GOVERNMENT OF INDIA DURING THE PERIOD 1950-51 TO 1959-60

Million Rupees

	Revenue Account		
	Revenue	Expenditure	Surplus or Deficit
1950-51	4,059	3,466	+5,922
1951-52	5,095	3,814	+1,281
1952-53	4,183	3,794	+ 389
1953-54	4,004	3,919	+ 85
1954-55	4,410	4,075	+ 335
1955-56	4,812	4,407	+ 405
Total First Plan period[a]	22,325	19,830	+2,495
1956-57	5,632	4,738	+ 894
1957-58	6,734	6,313	+ 421
1958-59	6,702	6,755	- 53
1959-60	7,786	7,360	+ 426
Total Second Plan (first four years)	26,854	25,166	+1,687

Sources: *Reserve Bank of India Bulletin* (April, 1961), p. 492; Reserve Bank of India, *Report on Currency and Finance, 1956-57*, Statement No. 56, and *1960-61*, Statement No. 55.

[a] Figures for the individual years may not add up to the total, because of revision.

TABLE 51 -- Continued

Capital Account			
Receipts	Disbursements	Surplus or Deficit	Overall Surplus or Deficit
1,045	1,826	- 781	- 37
2,127	2,934	- 807	+ 446
290	1,242	- 952	- 645
977	1,872	- 895	- 810
1,773	3,664	-1,891	-1,424
2,810	4,709	-1,900	-1,599
10,536	16,981	-6,445	-4,031
3,028	6,168	-3,140	-1,848
2,976	8,431	-5,455	-4,586
5,905	8,132	-2,227	-2,219
7,579	9,582	-2,003	-1,696
1,4488	32,313	-12,825	-10,349

ficant part"[1] along with monetary measures.

The period following a major shift in the monetary policy in November, 1951, till the end of the First Plan (March, 1956) may be characterized by the accelerated tempo of economic activity. There was a continuous rise in the industrial production. Agricultural production, after reaching the peak level in 1954-55, showed a slight decline in 1955-56. Consistent with the higher level of economic activity the money supply, too, recorded a continuous rise and by 1955-56 outpaced the rise in production levels and the economic activity. As the earlier analysis of this study has shown, in the Indian economy inflationary pressures began to mount from about 1954-55, and were intensified in the following years. This was reflected in the movement of selected monetary indicators. While the wholesale prices decreased by 14.0 per cent during the period 1950-51 to 1955-56, the index actually showed appreciable advances during the last two years of the First Plan. The main expansionary factors were increased developmental outlay, both by the public and private sectors, growing deficit financing and a rise in the bank credit. On the other side of the scale the availability of foodgrains acted somewhat as a contractionary factor.

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[1] Singh, op. cit., p. 253.

It is only since about the closing years of the First Plan that the monetary policy was called upon to play its major role in assisting economic development. And although no major shift was recorded in the Reserve Bank's policy during the First Plan (that is, after the November, 1951, change), the Bank duly emphasized the need for a careful and continuous assessment from time to time of the current economic situation in general and the pace and pattern of planned development in particular with a view to making appropriate adjustments in its policy.

Beginning with the Second Plan the monetary policy underwent another major change. The Second Plan was implemented in April, 1956, when the rapidly increasing rate of investment was leading to the continued rise in commodity prices, increasing cost of living, acute monetary stringency in the financial market, and the rapidly deteriorating foreign exchange situation. There was an unprecedented demand for bank credit in the economy which was reflected by the progressively increasing advances-deposits ratio. While a substantial portion of this bank credit was demanded for meeting the genuine needs of trade and industry, there were definite reasons to believe that the credit extended against certain commodities -- especially foodgrains and cotton textiles -- were very large. It was also observed by the authorities that in certain cities in India bank credit was utilized for speculative hoarding of paddy and rice.[1] Consequently a new phase of monetary management was entered into by the Reserve Bank which was characterized as the "policy of controlled expansion." The policy was initiated by resorting, in a systematic way, to selective credit controls and moral suasion on the one hand, and to the temporary liberation of the Bill Market Scheme and the revision of the open market policy on the other. In view of the special emphasis that the Reserve Bank put on selective controls during the Second Plan period, a detailed study of this instrument would seem appropriate at this point.

Although the Reserve Bank was vested with adequate powers to resort to the instrument of selective credit control as early as in 1949, no need was felt during the First Plan period by the authorities to use this instrument. Since the beginning of 1956, and especially after the implementation of the Second Plan in April, 1956, monetary indicators moved readily upward in response to the rising money incomes generated by large-scale development expenditures. Initiated by these developments early in 1956 the Bank operated for the first time the instrument of selective credit control in a systematic way.[1] Since then this instrument was used quite frequently by the Bank, although in a discriminatory manner. In fact it may not be an exaggeration to state that the emphasis shifted from quantitative to selective controls since the time the latter were first initiated.

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[1] These details were obtained by the Reserve Bank by conducting fortnightly surveys.

The official preference for selective controls is based on the following arguments. In the process of India's economic development there is a legitimate and essential need for higher bank credit to be channeled into desirable avenues which in turn would encourage investment. Quantitative credit controls discriminate against "legitimate" uses of bank credit. Selective credit controls, on the other hand, are designed to restrain particular types of investment or consumption. What is more important regarding selective controls, however, is the fact that they serve to divert the flow of bank credit into the areas most desirable from the point of view of economic development. They have an added advantage in that their operation can be discriminatory not only in regard to advances against different articles but also within the field where the controls are being imposed.

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[1] The Reserve Bank did use selective controls in the form of directives for regulating the expansion of bank credit in 1943, 1944, 1947, and 1950. However, with the exception of the one relating to raw jute (in respect of which advances other than to mills and balers were recalled), these directives contained only a general request for not lending discriminatingly against the commodities.

Conditions that led the Reserve Bank to take selective control measures for the first time in May, 1956, may now be examined in detail. The first measure of selective control almost coincided with the implementation of the Second Plan and also with the peak of the 1955-56 busy season for very definite reasons. It was noticed earlier that the First Plan picked up in 1953-54 and during the years 1954-55 and 1955-56 the level of economic activity was high and progressively increasing. By way of an illustration, the total investment of the public sector, which amounted to Rs. 3,430 million in 1953-54, rose to Rs. 4,759 million in 1954-55, and to Rs. 6,665 million in 1955-56. A progressively increasing portion of this investment was financed by borrowing from the Reserve Bank; the Bank's net credit to the government increased by Rs. 234 million in

1953-54, by Rs. 822 million in 1954-55 and by Rs. 1,646 million in 1955-56. Consistent with these developments the demand for bank credit also rose significantly. The 1954-55 busy season expansion in the bank credit of Rs. 982 million was of a far smaller magnitude as compared to the increase in bank credit during the busy season of 1955-56, which was of the order of Rs. 1,645 million -- the highest figure in any busy season since the implementation of the First Plan. Besides, the traditional slack season contraction of Rs. 316 million during 1955-56 was also comparatively small. Reflecting these trends, the money supply increased during the year 1955-56 by Rs. 2,643 million to a record of Rs. 21,845 million, as revealed by Table 52. While the general economic condition was booming the character of the movement in the bank credit was causing concern. Early in 1956 the Reserve Bank felt that at least a substantial portion of the busy season expansion in the bank credit was utilized for speculative holding of agricultural commodities. Consequently the Bank asked the scheduled banks to submit monthly statements showing the advances made by them against certain specified commodities and bullion, which was later (in April) substituted by fortnightly statements. By May, 1956, the general index

TABLE 52

MONEY SUPPLY WITH THE PUBLIC DURING THE PERIOD 1950-51 TO 1959-60

Year	Money Supply	Variations in Money Supply	% Change over Previous Year
	Million Rupees	Million Rupees	%
1950-51	19,711	+1,127	+ 6.1
1951-52	18,038	-1,749	- 8.9
1952-53	17,647	- 391	- 2.2
1953-54	17,940	+ 293	+ 1.7
1954-55	19,206	+1,267	+ 7.0
1955-56	21,845	+2,643	+13.8
1956-57	23,129	+1,289	+ 5.9
1957-58	23,894	+ 771	+ 3.3
1958-59	24,996	+1,099	+ 4.6
1959-60	27,031	+2,050	+ 8.1

Source: Reserve Bank of India, *Report on Currency and Finance, 1950-51* through *1960-61*.

of prices had risen in one year by 14.5 per cent. Most of this rise was brought about by the rise in the price index for cereals which increased during the period April 2, 1955, to May 26, 1956, by 34 per cent. It was feared in informed circles, including the Reserve Bank, that a substantial portion of this rising trend had been brought about by the speculative holding of foodgrains using bank credit. The survey conducted by the Reserve Bank confirmed this fear. It was observed from the survey that advances against paddy and rice increased from Rs. 116 million at the end of March, 1955, to Rs. 246 million on the same day in 1956, and further to Rs. 387 million in May, 1956 -- indicating a rise of 225 per cent in 14 months.[1] Further, the data collected by the Bank from 20 large scheduled banks which were responsible for 60 per cent of the total bank loans showed that the stocks of rice and paddy pledged or hypothecated with these banks increased from 492.9 thousand tons in May, 1955, to 815.2 thousand tons in May, 1956 -- an increase of 65.4 per cent as against a rise in the total output of this commodity by only 6.8 per cent between 1954-55 and 1955-56.[1]

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[1] S. N. Sen, "Selective Credit Controls:. The Indian Experiment," Arthaniti, II, No. 1 (November, 1958), 43.

This conspicuous rise in the prices of paddy and rice ensuing presumably from enhanced hoarding financed from easy bank credit made it imperative that banks should be directed to refrain from excessive lending against these commodities and should not assist in the speculative holding of stocks. In May, 1956, therefore, under the Banking Companies Act the Bank issued a circular letter to all scheduled banks and two state-associated non-scheduled banks impressing upon them the need to refrain from excessive lending against certain specified commodities and also from assisting speculative hoarding of stocks of these commodities. In addition they were directed not to increase any credit limits in respect of advances against the security of paddy and rice or sanction any fresh credit limit in excess of Rs. 50,000 in respect of such advances. These banks were further advised to refrain from increasing the existing margin in respect of the limits and advances by an amount not less than 10 per cent of the value of those commodities. Finally, banks were also requested to make a sincere attempt to reduce their aggregate advances against paddy and rice to a level not exceeding 25 per cent above that prevailing at the corresponding time of the previous year.[1]

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[1] Government of India, Report of the Foodgrains Enquiry Committee, 1957, p. 40.

Immediately following the directive the volume of bank advances against paddy and rice continuously declined from Rs. 229 million on May 25, 1956, to Rs. 75 million on August 31, 1956 -- a decline of 67.2 per cent as compared to a fall of 46.7 per cent during the corresponding period of 1955.[2] Nevertheless the total of their advances against paddy and rice remained higher than that in the same period of the preceding year by 52.0 per cent in June, 1956, 52.3 per cent in July, 30.0 per cent in August, and 30.5 per cent in September, 1956.[3] Moreover, the 25 per cent limit prescribed in the directive was reached only in October, 1956 -- six months from the date of the issue of the directive. Finally, bank advances against paddy and rice were again higher by 36.2 per cent in November, 1956, than the corresponding month of the preceding year.

It is interesting to note that while the advances against the commodities mentioned above declined subsequent to the issue of the directive, advances against other items rose significantly presumably because no restrictions were imposed on them. Thus, while advances against paddy and rice declined, those against shares and debentures of joint stock companies (excluding the amount granted to brokers and dealers) increased from Rs. 384 million on May 25, 1956, to Rs. 438 million on June 15, and further to Rs. 450 million on June 29, 1956. Advances against this item had been declining during these months in previous years. Advances against other miscellaneous commodities also increased from Rs. 352 million to Rs. 412 million, while these declined during the same period in the previous four years.

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[1] Sen, op. cit., p. 44.

[2] Ibid., p. 45.

[3] Ibid.

To sum up, following the May, 1956, directive, while bank advances against paddy and rice did decline more than in proportion to the previous year's trend, those against certain other items increased. In consequence, total bank advances, which stood at Rs. 7,690 million on May 25, 1956, declined to Rs. 7,350 million on August 31 -- a reduction of only Rs. 340 million, which was definitely smaller than the normal slack season decline. Finally, prices of paddy and rice, which after all were the target of attack, continued to rule firm despite the reduction of bank advances against foodgrains, the index of prices of these commodities rising from 93 in May to 100 in August, 1956 -- a rise of 7.5 per cent.

In addition to selective credit controls the authorities also resorted to general control measures. The open market policy underwent another major shift in November, 1956, when the Bank decided to extend its "discriminating support" to the gilt-edged market to relieve acute stringency in the market. This qualified support of the bond market was designed to assist the smooth functioning and progress of the Second Plan. Subsequently, as the Plan gradually progressed the price situation and with it the cost of living and the foreign exchange position further deteriorated. At the same time speculative activities continued. The Reserve Bank therefore tightened its control further by raising, on May 16, 1957, its rate by 0.5 per cent to 4 per cent. The Bank also used moral suasion in the form of letters of request to banks in order to control the inflation.

It is noteworthy that the circumstances that disposed the Bank to increase its rate in 1957 were different from those prevailing in 1951; this time the Bank rate _followed_ the important market rates, which was in sharp contrast to the Bank rate _leading_ the market rates in 1951.

The primary reason for the Bank rate increase in 1957 was, as stated by the Reserve Bank, the unification of the Reserve Bank's lending and borrowing rates. Since 1952 the usance bill rate under the Bill Market Scheme had ruled at 3 per cent. As time rolled on the Scheme showed marked progress, which was accompanied by a rise in the deposits and investments of scheduled banks. With effect from March 1, 1956, therefore, the Reserve Bank enhanced its lending rate under the Reserve Bank Act from 3 per cent to 3.25 per cent and simultaneously withdrew the concession in respect to stamp duty. In November the rate was further raised to 3.5 per cent; and in February, 1957, the stamp duty on usance bills was also raised, making the effective rate of borrowing under the Bill Market Scheme equal to 4 per cent.

Since February 1, 1957, therefore, the cost of central bank credit to scheduled banks ruled at 4 per cent. It may be noted that this rate, chargeable to scheduled banks obtaining credit from the Bank either against government securities or against usance bills, is usually referred to as the "lending rate" of the Bank, while the interest borne by the government on their created money, i.e., on the *ad hoc* Treasury bills sold in favor of the Reserve Bank, is known as the "borrowing rate." Since February, 1957, there manifestly arose a discrepancy between the _borrowing rate_ and the _lending rate_. An increase in the borrowing rate from 3.5 per cent to 4 per cent on May 16, 1957, consequently unified the two rates.[1] Thus "the raising of the various lending rates of the Bank was mainly by way of realignment with the trend of money market rates and was also directed to making the structure of lending rates of the Bank internally more coherent."[2] This unusual manner of raising the Bank rate, it was disclosed, was designed to "minimise disturbance to the money and gilt-edged markets."[3] It may be added that apart from the alignment aspect of the increase, booming conditions prevailing in the money market had also demanded hardening of the interest rates.

To sum up, it was against this background of high inflationary pressures, acute stringency in the market, and the desire of the authorities to align the interest rates that the Bank rate was raised in May, 1957. The Reserve

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[1] With a lowering of the stamp duty on usance bills to 0.2 per cent, the effective rate on advances under the Bill Market Scheme was further raised to 4.2 per cent.

[2] Reserve Bank of India, _Report of the Central Board of Directors for the Year Ending June, 1957_, p. 15.

[3] _Ibid._

Bank recognized that

> while there was the need for expansion of credit and money supply commensurate with the rapid development and diversification of the economy . . . an excessive expansion of money supply would be inflationary and would ultimately jeopardise the financial stability of the economy.[1]

Thus with the major shift in the monetary policy that was brought about in 1956 and 1957 the authorities entered into an era of what was called the "restrictive credit policy designed for controlled expansion."

As a combined result of monetary (that is, the Bank rate, open market policy, selective controls, and moral suasion) and non-monetary (that is, fiscal and other) measures, a marked improvement was recorded in the economy. The scheduled bank credit, which stood at Rs. 9,354 million on May 10, 1957, and reached Rs. 9,383 million on June 7 -- the highest level in 1957 -- was progressively brought down to Rs. 8,571 million by the end of the year. The scheduled bank credit increased from Rs. 9,000 million in March, 1957, to Rs. 9,627 million in March, 1958, or a total expansion of only 7.0 per cent as compared to an increase in bank credit of 18.2 per cent in 1956-57. The advances-deposits ratio also declined from 76.6 per cent in 1956-57 to 62.7 per cent at the end of 1957-58. It is noteworthy that, while in 1957 the adoption of restrictive policies resulted in a fall in the advances-deposit ratio from 76.6 per cent to 62.7 per cent between May 10 and December 27, in the corresponding period of 1956 when no such measures were taken the fall in the advances-deposit ratio was from 73.0 per cent on May 11 to only 71.6 per cent on December 28, 1956. This was indicative of the effectiveness of the various control measures taken by the authorities in reducing the pressure on bank credit.

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[1] *Ibid.*, p. 14.

Improvements were recorded in other sectors of the economy as well. With pressure on the bank credit substantially easing, scheduled banks repaid a considerable part of their indebtedness with the Reserve Bank, as may be seen from Table 53. These banks also seized this opportunity in building up their government securities portfolio. Consequently, between May 10 and December 27, 1957, investments of scheduled banks in government securities went up by Rs. 893 million to Rs. 4,334 million, the ratio of investments to deposits increasing from 28.2 per cent to 31.7 per cent. In addition to the above developments the rate of expansion in the money supply also slowed down, with the result that over the year 1957-58 (March, 1957, to March, 1958) the money

TABLE 53

SCHEDULED BANK BORROWING FROM THE RESERVE BANK DURING SELECTED YEARS

Million Rupees

Year	Amount
1950-51	124
1955-56	651
1956-57	1,032
1957-58	420
1958-59	619
1959-60	794

Source: Reserve Bank of India, Report on Currency and Finance, 1959-60, Statement No. 27.

supply increased from Rs. 23,129 million to Rs. 23,894 million, or an increase of 3.3 per cent as compared to an increase (Rs. 1,289 million) of 5.9 per cent in the previous year. Consistent with the declining trends in the money supply and bank credit, wholesale prices declined (with a few exceptions) from early August in 1957 till February, 1958; in consequence the index of wholesale prices declined from 110.4 to 106.1 during the period March, 1957, to March, 1958, or a fall of 4.0 per cent as compared to a rise of 7.8 per cent in 1956-57.

There was a notable improvement in the trade position of the country as well. The progressively improving balance of payments position was clearly reflected in the slowing down of the rate of loss in foreign exchange reserves; the average weekly decline of Rs. 78 million in the quarter July-September, 1957, was reduced to Rs. 21 million in the quarter January-March, 1958.

How far the monetary instruments were solely responsible for bringing about the improvements noted above is hard to determine. The Reserve Bank, however, claimed that during the latter part of 1957, primarily because of the instruments of monetary control, "symptoms of *some slackness* developed in the economy."[1] (Italics supplied.)

The improvements noted above proved rather short-lived, however. During the last two years of the ten-year period, namely, 1958-59 and 1959-60, inflationary pressures again mounted at an accelerated rate, foreign exchange reserves touched alarmingly low levels, and the demand for bank credit persistently increased. These developments caused considerable concern in informed financial circles. During this period there was a definite preference on the part of the Reserve Bank for selective controls as against quantitative controls, the former having been imposed not only on foodgrains but also on shares, groundnuts, and oilseeds. The frequency with which these controls were imposed was also unprecedented. In addition to selective controls, moral suasion in the form of letters of request to leading banks, which had been temporarily abandoned in 1958, was again revived in 1959 in order to emphasize to banks the graveness of the situation and appeal to their voluntary cooperation.

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[1] Reserve Bank of India, *Report on Currency and Finance, 1957-58*, p. 1.

As mentioned earlier the Reserve Bank also used the variable reserve requirements in the first quarter of 1960. On March 11, 1960, a communique was issued to banks notifying the imposition of this control. It read:

> . . . the Reserve Bank hereby directs --
>
> (i) that every scheduled bank shall, with effect from the expiry of the 11th March, 1960, maintain with the Reserve Bank and additional average daily balance, which shall be in addition to the daily balance. . . , and
>
> (ii) that the amount of such additional average daily balance shall not be less than 25% of the amount by which its demand and time liabilities subsequent to the 11th March 1960 exceed its demand and time

> liabilities at the close of business on that date.[1]

It is observed from the communique that the Reserve Bank impounded 25 per cent of the additional deposits flowing into the banking system after March 11, 1960.

It is important to observe that, while scheduled banks could be legally called upon to maintain reserves with the Reserve Bank up to a maximum of 20 per cent of demand and 8 per cent of time liabilities, the Bank did not make any such distinction in resorting to this measure, nor did it relate the percentage to total deposits. Instead the Bank made the higher margin applicable at a uniform rate to all classes of deposits that would accrue after the date of the order. This method was followed presumably to accord a fair treatment to all types of banks and also to avoid penalizing those banks that had taken more pains to attract deposits.[2]

Table 54 provides the basis for the justification for imposing higher reserve requirements on the economy.

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[1] Reserve Bank, Trend and Progress of Banking in India, 1960, p. 132.

[2] "Controls on Bank Credit," Commerce, March 1, 1961, p. 450.

TABLE 54

SCHEDULED BANK INDICATORS FOR THE PERIOD 1955-56 TO 1959-60

Million Rupees

End of	Demand Liabilities (1)	Time Liabilities (2)	Total Deposit Liabilities (3)	Investment in Government Securities (4)
1955-56	6,357	4,154	10,432	3,599
1956-57	7,119	4,737	11,753	3,472
1957-58	7,459	7,355	14,512	4,405
1958-59	7,336	9,344	16,350	6,134
1959-60	7,940	11,412	19,020	7,147

Source: Reserve Bank of India, Report on Currency and Finance, 1959-60, Statement No. 27.

TABLE 54 -- Continued

Ratio of (4) to (3) (5)	Total Cash and Balances with Reserve Bank (6)	Ratio of (6) to (3) (7)	Total Bank Credit (8)	Ratio of (8) to (3) (9)
34.5	847	8.1	7,613	73.0
29.5	883	7.5	9,000	76.6
30.4	1,050	7.2	9,627	66.3
37.5	1,078	6.6	10,137	62.0
37.6	1,529	8.0	11,279	59.3

It will be observed from the above Table that over the period 1955-56 to 1959-60, which coincided with the first four years of the Second Plan, the total liabilities of scheduled banks increased by Rs. 8,588 million (82.3 per cent), time liabilities accounting for Rs. 7,258 million (69.6 per cent) of the increase. The reasons for the significant increase in time deposits[1] were: (1) a gradual spread of banking habits among the people, (2) accumulation of the P.L. 480 funds, and (3) concentrated efforts of banks to mobilize the savings of the people. The heavy deficit financing by the government financed by central bank credit was another important factor which not only led to an increase in the time deposits but in demand deposits as well. These banks utilized their deposit resources in increasing their advances, holdings of government securities, and cash and balances with the Reserve Bank, the respective increases during the period 1955-56 to 1959-60 being Rs. 3,666 million (48.2 per cent), Rs. 3,548 million (98.6 per cent) and Rs. 682 million (80.5 per cent). It is also noteworthy that, due presumably to the restrictive credit policies of the Reserve Bank, scheduled banks were not able to loan out the additional funds gained by them in the form of deposits with the result that the ratio of total bank credit to total deposit liabilities declined from 76.6 per cent in 1956-57 to 59.3 per cent in 1959-60. As a possible remunerative alternative these banks were induced to invest additional amounts in government securities, so that the ratio of investment in government securities to total deposit liabilities increased from 29.5 per cent to 37.6 per cent over the same period. It is evident, therefore, that in recent years scheduled banks had mobilized enough potential liquid resources, which considerably enhanced their lending capacity. Furthermore these banks also had access to the alternative sources of finance, such as borrowings under the Bill Market Scheme, loans from the Industrial Finance Corporations, and so on. The increased reserve requirements thus aimed at sterilizing a part of the potential liquidity of the banking system.

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[1] Reserve Bank, Trend and Progress of Banking in India, 1959, p. 4.

An overall summary of the efforts of the Reserve Bank to control the new inflation and its influence on the Indian economy may now be attempted. During the First Plan period as a whole the national income rose by 18.4 per cent, food production went up by 27.3 per cent and the money supply (currency and demand deposits) by only 10.3

per cent. The index of wholesale prices fell by 14.0 per cent.

Within the First Plan period, two distinct trends were noticed. Between 1950-51 and 1952-53 the index of national income rose from 92.3 in 1949-50 to 100.0 in 1952-53, or a total increase of 7.3 per cent, and the rise in foodgrains production was 17.3 per cent over the same period. The money supply, on the other hand, declined over the two-year period ending 1952-53 by 5.4 per cent. During this period wholesale prices also declined by 1.3 per cent. However, the index of money supply expanded from 102.2 in 1951-52 to 123.8 in 1955-56 or by 21.1 per cent, over a period of four years ending March, 1956, while the national income rose only by 4.8 per cent during the same period. Moreover, contrary to usual expectations the wholesale price index fell by 18.9 per cent. This was primarily the result of a substantial increase in the output of foodgrains, which increased by 26.5 per cent over the same period.

During the first four years of the Second Plan, that is, between 1955-56 and 1959-60, the money supply increased by 23.6 per cent and the national income by 12.2 per cent. The increase in the food production, being only of the order of 11.3 per cent, did not match the increase in the money supply. Also the heavy drains in the foreign exchange reserves proved inadequate for cushioning the effect of an accelerated increase in the money supply on the price level. Consequently the rise in the wholesale price index was 26.6 per cent during the first four years of the Second Plan. Finally the extension of credit to the government by the Reserve Bank for the financing of budget deficits without curtailing the total flow of credit to other areas was observed to be the prime cause of monetary expansion in the economy.

The Restrictive Role of Monetary Policy

For a critical evaluation of the restrictive role of monetary policy a brief resume of the basic issues of economic development in the present phase and conditions of the Indian economy is essential. In the month of April, 1951, India embarked upon the long and hazardous road of economic development through a series of government-sponsored Five Year Plans to lift the economy of the country from poverty to prosperity, from widespread want to broad-based welfare. The basic aim, as stated by the government of India, was to bring about a definite and marked improvement in the levels of living of the mass of population in the country through an increase in the aggregate as well as per capita output. The government also aimed at improving the national output or income through a reduction in the inequalities of income, wealth, and opportunity together with an increase in income and an improvement of employment. A realization of these aims required a substantial stepping up of investment appropriately allocated and duly balanced by sectors and industries.

An investigation into the developments that took place in the Indian economy during the Plan period revealed that at the end of March, 1959, the ratio of investment to national income was approximately 10.7 per cent, whereas savings in the economy formed only about 7.5 per cent of the national income. This imbalance between savings and investment in the Indian economy puts in perspective the problem of raising internal resources to match the higher rate of investment. So long as savings fall short of the intended investment, the gap has to be filled in by (1) taxation, (2) borrowing out of current savings, (3) foreign grants, and (4) deficit financing _in the Indian sense_, namely, borrowing from the banking system and creating more money in consequence. Crucial to the understanding of the financing of the development plans is the fact that essentially it is not a question of which of the above methods are inflationary -- for they are all inflationary -- but it is rather a question of determining which method is most inflationary. Generally, in the case of an underdeveloped economy deficit financing in the Indian sense is more inflationary in character than the other three methods of bridging the budgetary gap mentioned above.[1] For this reason deficit financing has spiral effects of a rise in costs and wages and in estimates of expenditure of various projects or shortfalls in the attainment of targets in real terms. If, therefore, the method of deficit financing is resorted to, not only does there arise the danger of dislocation and disruption of the development program, but also under this type of financing people in the low-income bracket are affected more seriously while the wealthy business community stands to benefit. Inflation beyond a certain limit also has other far-reaching repercussions. Domestic inflation invariably affects the country's balance of trade adversely; since it unfavorably affects the country's exports by raising the costs, and simultaneously swells the potential demand for imports.[1] Consequently a dogmatic faith in deficit financing in the conditions existing in the Indian economy is liable to undermine the very basis of development.

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[1] For detailed economic justification of this idea see B. K. Madan, "The Role of Monetary Policy in a Developing Economy," Reserve Bank of India Bulletin (April, 1961), p. 522.

In order to provide the necessary framework for an evaluation of monetary policy it seems timely to reiterate that the primary cause of the Indian inflation, as observed earlier, was the massive deficit financing undertaken by the government. It may be noted in this context that nations have been forced in the past to use deficit financing during wartime on a colossal scale for unproductive schemes, often with disastrous results. This does not mean that this technique cannot be resorted to in peacetime. In fact, in a country racing against time to complete its development plan the budgetary gap can be a useful instrument of fiscal technique. In his budget speech in 1953 Mr. Deshmukh, the ex-Finance Minister of India, rightly observed that ". . . so long as the domestic price situation is well in hand, and there are external reserves [that is, foreign exchange balances] which can drawn upon in the case of need, deficit financing for development involves very little risk,"[1] and that "deficit financing, subject to safeguards has a definite part to play in bringing into use the unutilised resources in the system."[2] "It was, therefore, important," continued Mr. Deshmukh, "not merely to live within our means but also live up to our means."[3] Mr. Deshmukh's statement is very enlightening, since it signifies the rôle of deficit financing in India's economic development. But it also emphasizes that this technique can be used for developmental purposes _only on a limited scale_, provided the resultant inflationary pressures were kept constantly under control. While no single guide could help in the determination of the "safe limit" of deficit financing, _a substantial increase in the national income accompanied by a mild dose of inflation_ would probably provide the best guide in determining the magnitude of deficit financing which the economy could bear without significantly affecting the value of the currency. Our analysis has brought out the fact that, owing to the heavy deficit financing, real growth in India considerably slowed down. In short the Reserve Bank was directed to help finance the Plans even though that might adversely affect its authority to maintain stability in the economy.

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[1] In India, for instance, while the exports remained at an average of about 65 per cent of the pre-war level, imports were sealed at about 90 per cent of that level by the imposition of exchange controls and import restrictions.

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[1] _Eastern Economist_, January 8, 1960, p. 218.

[2] _Ibid_.

[3] _Ibid_.

Precisely, then, the government of India accepted the thesis that the efficient mobilization of resources and the attainment of the Plan objective of a balanced development of the economy was primarily dependent upon its success in raising internal resources _largely through non-inflationary means_. Nevertheless it still resorted to the easiest but the most vulnerable method of deficit financing which proliferated heavy inflationary strains. To control the new inflation the Reserve Bank applied in varying degrees and frequency _all_ the monetary brakes in its possession. The success or failure of monetary policy, however, depended to a large extent not only upon the dexterity with which these brakes were applied but also significantly upon the structural framework within which the monetary policy had to function. A brief recapitulation at this point of the developments that took place in the institutional setup may therefore seem appropriate.

A factor which limits the scope of the central bank in India is the relative importance of the unorganized sector (as compared to the organized sector) of the money and capital markets. In 1930, when the Central Banking Enquiry Committee published its report, the unorganized sector was estimated to cover approximately 90 per cent of the market. Over the years, however, important developments have taken place in the market structure in India. It is currently estimated that the unorganized sector comprises only about 50 per cent of the total market, which necessarily broadens the scope of monetary policy.[1]

Not only has there been a rapid development in the money market but also there have been growing connections between the unorganized and the organized sectors, as the resources of indigenous bankers and moneylenders are replenished through recourse to commercial banks. Commercial and cooperative banks extend their operations through an expanding network of branches to all parts of the country. Moreover, in the Indian economy the fact that 90 per cent or more of the bank credit extended during the so-called "busy season" (November to April) is withdrawn in the form of currency and very little is reflected in increased bank deposits, indicates the process by which the unorganized sector draws upon the organized sector. This, too, has a salutary effect on the broadening of the scope of credit policy.

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[1] The rate of monetization in the Indian economy is assumed to be approximately 1 per cent per annum. See Reserve Bank of India Bulletin (July, 1961), p. 1046.

Another important development that took place in India relates to the predominance of currency in the total money supply. Traditionally, unlike developed countries, a large percentage of currency in the total money supply has been an important characteristic of the Indian monetary system. Since the central bank regulates the commercial banks through the control of their demand deposits, this situation obviously restricts the effectiveness of central bank control. While this is basically true, recent developments indicate that the relative importance of currency and total bank deposits has been altered by the phenomenal growth of time deposits; from 40 per cent of the total deposits in 1953 and 1954, time deposits have risen to 60 per cent in 1960. Thus, while currency still remains the predominant part of the money supply, being about 70 per cent of the money supply, total bank deposits now are at about the same level as currency, unlike in 1953-54 when currency was much larger. Obviously this development further widens the scope of the monetary authorities.

Another factor which is worth mentioning in this context is the high proportion of expansion for bank credit during the "busy season" that is made by recourse to the Reserve Bank through borrowing against government securities and bills. During the busy season of 1959-60, for instance, of the increase in bank credit of Rs. 1888.5 million, 17.1 per cent was reflected in increased borrowing (against bills purchased and discounted) from the Reserve Bank. This proportion was 2.5 per cent in the previous (1958-59) busy season. This dependence of commercial banks on the central bank credit in India is not like the conditions that exist in countries such as the UK, where the market rates usually act as a penalty rate that becomes effective only in times when pressure on demand for funds leads to borrowing from the central bank. The position in India is rather more like that in Germany or Japan where borrowing from the central bank is more frequent and continuous. It is true that this type of relationship does not by itself increase the ability of the Reserve Bank to influence monetary conditions. Nevertheless the fact of greater dependence of commercial banks on the central bank borrowing -- and this borrowing is not wholly for seasonal purposes -- does enhance the ability of the Reserve Bank to influence the credit policies of banks.

Finally, a factor which increases somewhat the relative efficacy of the central bank's policy in India is the relative absence of liquid assets owing to the inadequate growth of such financial institutions as building societies, finance houses, hire-purchase companies, etc., which are, with their large independent resources in other countries, important constituents of the capital market. This inadequate development of the capital market in a way increases the importance of commercial bank lending and thereby broadens the central bank's control on the entire market. It also accounts for the larger role of the central bank in the promotion and development of institutions of the capital market.

What has been said above only suggests that on the one hand, over the Plan period, the scope of monetary policy in India was considerably widened and deepened; on the other, the burden of monetary policy was considerably magnified as it was charged with the onerous task of controlling the new inflation, which incidentally was the result of the deliberate subordination of monetary policy to fiscal policy. The complexity of the Reserve Bank's job was further aggravated by "certain shifts in the distribution of income in the community as well as change in the balance between the public and private sectors."[1] It is within this frame of reference that the monetary policy of the Reserve Bank has to be evaluated and criticized.

The Reserve Bank, it may be recalled, applied its credit control measures to (1) regulate the cost of credit, (2) control the quantum of credit, and (3) give purposive direction to the use of credit. As regards (1) and (2), the instrument that was frequently employed in recent years was the open-market operations conducted by the Reserve Bank. The Bank rate was increased only on two occasions -- once at the beginning of the First Plan and again soon after the Second Plan was launched. The instrument of variable reserve requirements was also used once only in the last month of the period under observation. As regards (3), selective credit controls were used fairly widely during the Second Plan period primarily in applications to advances against foodgrains and other selected articles or raw materials like sugar or groundnuts, temporarily to cotton textiles, more recently to jute goods and raw jute, and during the last year also to regulation of the margin of advances against shares.

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[1] Madan, _op. cit._, p. 531.

A criticism of each of these instruments of credit control may now be undertaken. Open-market operations, as explained earlier, can be used informally by the Reserve Bank, in the form of selling or buying government securities and thereby influencing banks' liquid reserves in the desired direction. In practice, however, the Reserve Bank mainly engaged in selling (rather than buying) securities to the banks, constantly endeavoring to dispose of larger volume of government securities in order to bridge the budgetary gap that was created by the government's deliberate use of deficit financing. What is of greater significance, however, is the fact that, because of limited capacity, the market failed on many occasions to absorb government securities, with the result that the Bank had to purchase a large number of these securities itself to facilitate the deficit financing. In practice, "open market operations . . . [thus became] primarily an ancillary to Government debt management."[1]

It is manifestly clear that open-market operations lost much of their significance as an effective instrument of quantitative credit control. However the Reserve Bank is not to blame for this, since it was virtually constrained to feed the accelerating machine of deficit financing.

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[1] *Ibid.*, p. 534.

Turning to the Bank rate as an instrument affecting the cost of credit, it is observed that this instrument of general control was neither used frequently nor on any considerable scale. The Bank rate remained practically pegged to a static rate (at 3 per cent) since the inception of the Reserve Bank until 1951 when, consistent with a more dynamic monetary policy, the rate was increased to 3.5 per cent. The effective rate was, however, maintained at the earlier level, namely 3 per cent, through the institution of the Bill Market Scheme which offered to banks a ready means of access to the Reserve Bank on the basis of usance bills created for the purpose. Again, after a lapse of almost four and a half years, when inflationary pressures began to mount rapidly, the effective rate of lending by the Reserve Bank was raised to 4.2 per cent against bills (inclusive of stamp duty), and 4 per cent against government securities. Since then the rate had been static at that level.[1]

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[1] Although it is outside the scope of the present study, it is of considerable importance to note that in September, 1960, a system of graded lending rates was introduced by the Reserve Bank, with the Bank rate (the basic rate of lending by the Bank) unaltered. Under this system,

Mr. Rama Rau, ex-Governor of the Reserve Bank, who steered the Bank for the most part of the period under study, recently justified the limited use of the Bank rate. He averred that because of the following reasons the authorities felt it unnecessary to recommend any further increase in the Bank rate than was effected by the Reserve Bank.[1] Analyzing the impact of an increase in the Bank rate on the three important sections into which the business and developmental activity were divided and which were influenced by the Bank rate, Rau said that insofar as the public sector was concerned, a higher rate would have

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quotas of borrowing at Bank rate were stipulated for scheduled banks equal to 50 per cent of their statutory deposits with the Reserve Bank, a rate of 1 per cent (namely, 5 per cent) above the Bank rate being chargeable for borrowing in excess of the basic quota up to an amount equal to the basic quota, any further borrowing above this additional quota being chargeable at a rate of 2 per cent above the Bank rate, namely, 6 per cent. In effect, this system of graded rates involved a marked increase in the average rate on all borrowing from the Reserve Bank, which was above 5 per cent.

Another important change in this regard was the practical winding up of the quasi-central banking function of the State Bank of India in acting as a bank of intermediate resort. The State Bank also raised its lending rate to other banks from 4 and 4-1/4 per cent to 6 per cent at all larger cities where an office of the Reserve Bank was located, and to 5 per cent for limited amounts at other centers. For details, see Reserve Bank of India Bulletin (April, 1961), p. 535.

[1] See Commerce, April 30, 1960, p. 746.

increased the cost of government borrowings at a time when the government desired to raise large sums of money for the Plan. The government would in that case be stultifying itself in its efforts to increase production by rapid development if, after having decided on an ambitious program of expenditure, the government imposed impediments in its way by raising the rates of interest on government loans. Continuing the same line of argument, Mr. Rau said that, as regards the private sector, there had been a substantial increase in the investment and he saw no justification for raising the Bank rate, which would have imposed obstacles in the way of development in this sector.

Perhaps the only sector, Mr. Rau opined, where a higher Bank rate could be more effective when there was speculative hoarding of stocks with the assistance of bank advances in order to push up prices, was the private trading sector, directly on a selective basis. And even there the effect of a higher Bank rate could only be temporary, for it could not be a substitute for fiscal and other disinflationary measures designed to produce a balanced economy.

Mr. Rau's reasoning is appropriate and justifies the limited use of the Bank rate in India. His critical evaluation also emphasizes the fact that, under Indian conditions, it is selective rather than general credit control that is called for to restrict the activities of certain specified sectors of the economy.

Besides open-market operations and the Bank rate, the Reserve Bank altered, for the first time, variable reserve requirements in March, 1961, in order to control and regulate the rapidly rising deposits of the banking system. The technique used by the Bank was somewhat different from the usual method of varying reserve requirements. The Reserve Bank required the banks to keep 25 per cent of the increase in deposits that occurred after a certain specified base date. This method of impounding the additional increase in deposits was justified on the grounds that the increase in deposits was unusually rapid and did not involve a more intensive effort on the part of banks to attract deposits (in the form of opening new branches, etc.). Justifying the increase in the reserve requirements, an official of the Reserve Bank stated:

> The incremental or additional reserve is more appropriate as a temporary expedient for exceptional liquidity situations, while changes in general reserves are more

> adequate as a longer-term structural adjustment to a situation of steadily improving liquidity in consequence, say, of continued deficit-financing.[1]

The effectiveness of this instrument cannot be adequately judged, since the requirements were tightened toward the end of the period under study. Nevertheless the technique that the Bank used in imposing these requirements bore testimony to its being versatile and alive to the special needs of the country.

We may finally turn to selective credit controls, which were most frequently used beginning May, 1956, in order to give a purposive direction to the use of credit. An analysis of these controls reveals that, although selective controls were used very extensively, their effectiveness in general was comparatively limited. And the success which was obtained through the imposition of selective controls was frequently a result of their being used with other instruments of credit control. While it is recognized that the effectiveness of such controls by their very nature is limited under conditions of general inflationary pressures generated by continued deficit financing, selective credit regulations against certain commodities of strategic importance to the economy would still appear to be necessary in order to make the monetary policy broad based. From this point of view, therefore, it would appear that frequent imposition of selective controls (alongside other monetary measures) broadened and enhanced the overall efficacy of the monetary policy in India.

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[1] Madan, *op. cit.*

An overall evaluation of the restrictive role of monetary policy in the developmental setup in India may now be attempted. Since about the middle of the ten-year period under study the economy showed distinct signs of "true" inflation. There was a steady rise of prices and cost of living, with the increase in the money supply and liquidity outrunning the pace of growth of the real national income. Of the sources of increase in the money supply, extension of bank credit to the government sector -- and more specifically an increase in the Reserve Bank credit to the government -- was predominantly significant. And although there was a rise in both agricultural and industrial production, the increase in monetary indices was appreciably larger than the increases in the agricultural and the industrial production, with a consequential drag in the rate of increase in the real income. While it is legitimate to establish the price rise as the cause of rapidly expanding bank credit, the contrary may also be true in an expanding economy. A rise in prices may very well justify the higher volume of bank credit since demand for credit might go up as a result of inflation. Partly, however, this becomes a vicious circle as higher bank credit stimulates a further rise in prices which eventually threatens to become "true" inflation. To break the vicious spiral "it might become necessary to restrain the expansion of bank credit, with some possible adverse consequences on growth of productive enterprise itself, in the interest of a more healthy and soundly based general economic advance."[1]

The Reserve Bank, it may be noted, was confronted with a very serious dilemma. On the one hand it was obliged to act as an important source of credit creation for financing the budgetary deficit and, on the other, the Bank was vested with the responsibility of controlling the inflation generated primarily by itself. In addition the Bank had to devise new and dynamic methods of implementing general and selective controls to cope with the everchanging conditions developing in the economy.

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[1] Ibid.

Our analysis has demonstrated that the Reserve Bank was largely successful in its restrictive role. For although the Bank could not fully prevent the inflation on which it had virtually no control, there was a very careful and continuous planning on the part of the Bank by way of implementation of the various instruments of credit control in a flexible manner in order to successfully play the promotional and developmental role over and above the regulatory. This called for a marked deviation from the accepted central banking techniques; and the Bank was successful, to a considerable degree, in partially controlling the inflation while at the same time helping the effective implementation of the Five Year Plans consistent with the total economic policy of the country.

To conclude, the restrictive role of monetary policy, which was to control the new inflation generated in the economy as a result of the implementation of the government-sponsored Five Year Plans, was a difficult one for several reasons. The new inflation was partly the consequence of non-monetary factors (such as, the declining availability of foodgrains) on which monetary authorities had no control. Further, in deciding the size of the Plans and the extent of deficit financing necessary to finance these Plans, the government virtually subordinated the monetary policy to fiscal policy, thereby making the task of the Reserve Bank immensely more difficult.[1] Finally, as mentioned before, since a small measure of inflation could be considered as consistent with the development process of an underdeveloped country like India, the authorities were confronted with the difficult problem of finding the delicate balance between the "safe" and the "excessive" quantum of inflation. In short, over the period under observation, considering the functional limitations and the institutional framework within which the Reserve Bank had to function -- as a "versatile and percipient" institution, the Bank protected the economy as best as feasible against disturbance of the even tenor of progress through judicious, skillful, and pliant employment of the specially devised techniques of monetary policy.

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[1] For instance, Mr. Iengar, Governor of the Reserve Bank of India, recently said: "The determination of fiscal policy is not a matter in which the Government is or can always be guided by the advice of the Reserve Bank . . . Sometimes, advice is asked for . . . But it must be clearly recognized that while there is an area which is very clearly the direct responsibility of the bank and an area in which Government and the Bank are both concerned, there is also an area which is very clearly the direct concern of Government." See H. V. R. Iengar, "Monetary Stability and the Role of the Reserve Bank," Reserve Bank of India Bulletin (November, 1960), p. 1610.

CHAPTER VIII

MONETARY POLICY IN INDIA:
THE DEVELOPMENTAL ROLE

The developmental role of the monetary authorities is to improve the efficiency of the banking system as a whole to extend sound credit where needed and to respond flexibly and promptly to changing conditions. More specifically, the developmental role of monetary policy comprises the attempts to do the following: (1) to improve the mechanism for the expansion of the money supply to meet the needs for deficit financing, (2) improve the effectiveness of monetary policy by enlarging its scope, (3) establish new institutions and reorganize the old ones for the deliberate promotion of institutional credit with a view to enlarging both the agricultural and industrial sectors and also to monetizing the economy, (4) reconstruct the banking structure, and (5) expand banking facilities in the country. The developmental role of the monetary authorities in India will be evaluated within this broad framework.

In India the monetary authorities appear to have accepted the hypothesis that the real national income cannot be raised effectively and in the most advantageous manner without a substantial increase in the money supply. Until 1956, there were statutory restrictions on the issue of currency. This deficiency in the financial framework was remedied by the enactment in July, 1956, of the Reserve Bank of India (Amendment) Act. This Act provided for the needed flexibility in the note issue, while maintaining a specified quantity of reserve in gold and foreign securities.[1]

It may be of interest to note that theoretically there is no reason why the domestic supply of the rupee should be tied to the country's foreign exchange reserves. The real purpose of foreign exchange reserves is to meet an unfavorable balance of payments and to use them in the operation of exchange stabilization funds. In India the linking of the note issue to foreign security reserves at the present time is a result of her past monetary history. As long as there was a statutory link between the pound sterling and the rupee, and the exchange value of the rupee was fixed at 1s 6d, it was necessary to maintain a certain ratio between the domestic money supply and foreign exchange reserves. Since there is no statutory link between the pound sterling and the rupee now, even the revised requirements of keeping Rs. 5,150 million in gold and foreign securities is really not essential. In fact several countries such as Canada, New Zealand, Australia, Israel, Ceylon, and the Philippines have no reserve requirements in the form of gold or foreign exchange against the issue of currency.

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[1] Details of the amended note issue provision are given in chapter III.

Once the legal restriction on the increase in the money supply was liberalized the authorities found it convenient to expand the nation's money supply consistent with the increased economic activity and a rising national income. Over the period July, 1956 (when the Amendment Act was passed), and March, 1960, the money supply with the public increased by Rs. 5,120 million to Rs. 27,010 million, an increase of 23.4 per cent. It would appear therefore that the above amendment made the expansion of the money supply easier to meet the increased demand for money arising out of a rapid monetization of the market, as also the heavy deficit financing undertaken by the government.

As regards institutional developments there is empirical evidence to show that the monetary authorities successfully accomplished, to a certain degree, the objective of developing financial and other institutions so as to make the monetary policy function more effectively. Early in the period under study (November, 1951) the Reserve Bank modified its open-market policy by "unpegging" the government securities market.[1] Under the new policy the Reserve Bank decided to refrain from buying government securities, save in exceptional circumstances, to meet the seasonal requirements of scheduled banks. This change in policy, designed to insure flexibility in the Bank's control of the economy, further enabled it to influence the pattern of bank advances; since, under the flexible open-market policy, banks had to resort to borrowing from the Bank to meet their seasonal demands. Furthermore the Bill Market Scheme introduced in January, 1952,[2] added considerable flexibility to the operations of the Reserve Bank and helped it to insure, although to a limited extent, that such advances were for bona fide trade purposes and for short periods. The Scheme was later liberalized in successive stages so that the facilities under it could be availed of by a larger number of banks. In addition to the above, the Bank also enlarged the scope of monetary policy in 1956 when the fixed reserve requirements of banks were replaced by the variable reserve ratio.[1]

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[1] Open-market policy has been discussed in chapter V.

[2] The Bill Market Scheme has been discussed in chapter III.

Besides the enlargement of the scope of monetary policy, the Reserve Bank was also confronted with the very important task of initiating the deliberate promotion of institutional credit for more than one reason. Before the First Plan was launched in April, 1951, a large part of the country was relatively non-monetized. Moreover, agriculture in many parts of the country was "of the subsistence type rather than commercial in character."[2] As a result there was little incentive on the part of the commercial banks to extend credit in such areas. But it is precisely these regions which were most in need of economic development. Hence there arose an urgent need for diverting the Bank's efforts to set up new institutions and refine the existing one to meet the growing needs for such institutions in the country.

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[1] For detailed discussion, see chapter V.

[2] B. Venkatappian, "The Role of the Reserve Bank of India in the Development of Credit Institutions," Reserve Bank of India Bulletin (January, 1961), p. 13. (R. R. Kale Memorial Lecture, delivered at the Gokhale Institute of Politics and Economics, Poona, April 6, 1960).

It was the agricultural sector that called for the immediate attention of the Reserve Bank. India is primarily an agricultural country, and the need for agricultural credit in an adequate measure can hardly be overemphasized. Until about the beginning of the First Plan attempts of the Reserve Bank to provide agricultural credit were inadequate and roundabout. With the amendments to the Reserve Bank of India Act in 1951 and 1953 the scope of agricultural credit by the Bank was considerably enlarged. By the Amendment Act of 1951, for instance, the period of maturity of bills drawn for the finance of seasonal agricultural operations or the marketing of crops, eligible for rediscount by the Bank, was extended from nine months to fifteen months. Also, the eligibility for rediscount of commercial paper was extended to bills bearing the signature of a state cooperative bank. The Amendment Act of 1953, on the other hand, extended the scope of the Bank in regard to the financing of mixed farming activities, and also dispensing medium-term agricultural credit to cooperative banks to a limited extent.

With regard to medium-term loans the 1953 Act empowered the Bank to grant loans and advances to state cooperative banks for agricultural purposes with a maturity of between fifteen months and five years up to a specified amount. The provision of five years was subsequently removed by a further amendment in 1955 which provided for the grant of medium-term loans out of the National Agricultural Credit (Long-Term Operations) Fund and the National Agricultural Credit (Stabilisation) Fund. Another major step in this regard was the enactment of the Agricultural Produce (Development and Warehousing) Corporation Act, 1956, a measure which made it possible for the Reserve Bank to grant loans and advances to the warehousing corporations.

The Reserve Bank was also active in developing the facilities for rural finance. Recognizing the inevitable need for reorientation of the rural finance, the Reserve Bank appointed in 1951 the Committee of the All-India Rural Credit Survey. The Committee, in its Report published in December, 1954, recommended a revitalization of the cooperative agencies for rural credit alongside the provision of storage and warehousing facilities and development of banking facilities in rural areas through a state-associated sector of commercial and cooperative banking. The recommendations covered an integrated scheme of rural credit based on three fundamental principles, namely, "(i) State partnership at different levels, (ii) co-ordination of credit and other economic activities such as marketing and processing and (iii) administration through properly trained personnel responsive to the needs of the rural population."[1]

As a first step in implementing the recommendations of the above Committee, the government established the State Bank of India in July, 1955, which took over the former Imperial Bank of India[2] -- the largest scheduled bank in existence in India. The State Bank was to undertake not only commercial banking functions on the usual banking principles, as the Imperial Bank did (that is, providing credit to industry, trade, and commerce, etc.) but also extend its activities to the rural sector of the economy.

Besides rural finance, the Reserve Bank took important steps to develop industrial finance. In the field of industrial finance the participation by the Reserve Bank did not become really significant until 1948, when the Industrial Finance Corporation of India (IFC) was established. During the ten-year period under study several institutions were established for making medium-and long-term loans to medium- and small-scale industries.[1] For instance, the State Financial Corporations were set up by an Act of 1951 to provide medium- and long-term credit to small and medium-sized industries which could not obtain loans from the IFC. Subsequently, in 1954 the National Industrial Development Corporation was set up for extending loans especially to jute and cotton textile industries; since these industries were considered the key industries in India. Besides, since the small industries were recognized as an important part of the industrial sector of the economy the National Small Industries Corporation was established in February, 1955, to assist these industries in obtaining credit. Further, in April, 1960, the Reserve Bank of India (Amendment) Act was passed, which empowered the Bank to act as the agent for the central government in guaranteeing the due performance by any small-scale industrial concern approved by the government of its obligations to a bank or other financial institution in respect of loans and advances made to it by such bank or other financial institution.

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[1] Reserve Bank of India, Report of the Central Board of Directors for the Year Ending June, 1955, p. 16.

[2] Details regarding the nationalization of the Imperial Bank of India are given in chapter III.

Various changes were also made in the existing institutions to make medium- and long-term industrial loans more easily available, which were considered necessary for the industrialization of the country. During 1957, for example, the State Bank of India Act was amended to enable it to grant medium-term credit to industries for a period of 6 months to 7 years. Later, in 1960, the Reserve Bank was authorized to extend the facility of medium-term loans to State Financial Corporations for periods not exceeding 18 months.

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[1] For details, see chapter III.

While the promotional aspect of institutional credit was an important task of the Reserve Bank, its role in the reconstruction of the banking structure was equally important. The reconstruction of the Indian banking structure implied, in effect, two separate tasks.[1] The first task involved the improvement of those unsound banking companies which conducted their business in a manner detrimental to the interests of depositors. The second and perhaps more difficult problem was to deal with such banks which, although sound institutions, did not basically serve the banking needs of the community. Obviously, to cope with problems of such a large magnitude, a many-sided attack was called for.

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[1] Reserve Bank of India Bulletin (August, 1961), p. 1222. (Speech delivered by H. V. R. Iengar at the Annual General Meeting of the Indian Institute of Bankers, Bombay, August 10, 1961.)

The Reserve Bank did take several measures to reconstruct the banking structure so as to make the whole structure progressively stronger and more dependable. For instance the Bank sought to safeguard the interests of depositors through the prescription of minimum capital and reserves of banks, varying according to the geographical coverage of their operations.[1] Banks were also required to maintain "secondary reserves," consisting of cash, gold, and certain approved securities amounting to at least 20 per cent of their total demand and time liabilities in India.[2] It was further required of every banking company incorporated in India to transfer out of its profits (before dividends) a sum of not less than 20 per cent of such profits to the reserve fund until the fund was raised to the level of its paid-up capital.[3]

Besides prescribing capital, surplus and liquid assets requirements the Reserve Bank also developed a system of periodic inspection of banks with a view to eliminating the unsound banks and improving the working of those banks which met the prescribed minimum standards. As the Reserve Bank itself put it: "The primary object of inspection . . . [was] to help banks develop sound banking traditions by inviting their attention to defects in their working."[1]

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[1] Reserve Bank, Functions . . ., p. 50.

[2] See Section 24 of the Banking Companies Act, 1949.

[3] See Section 17 of the Banking Companies Act.

The system of inspection provided the Reserve Bank with the opportunity to correct the unsound banking methods of the weaker banks. In the larger interests of the country, the Reserve Bank also developed an ancillary system of licensing. By this system the Bank granted licenses to those banks whose working was either satisfactory or could be improved if allowed to do so. On the other hand such banks which were below the level of minimum standards were refused licenses. The Reserve Bank assisted in the smooth liquidation of these banks without disrupting the public confidence in the banking system. In many instances, amalgamation of two or more banks was also suggested whenever it was felt that the amalgamated units would be able to play a more useful role.

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[1] Ibid., pp. 56-57.

A reconstruction of the banking structure cannot be a success unless the standards of the banking personnel are raised. The Reserve Bank had felt that in the larger part of India no progress would be possible unless very special efforts were made to train the banking personnel at all different levels. Consequently the Bank established in 1954 a Bankers' Training College to impart training in practical banking to the Indian bankers. Other efforts in this area included the establishment of the Cooperative Training College and the Central Committee for Cooperative Training College.

In the end, mention may be made of the final aspect of the developmental role of the Bank, namely, extension of banking. It is evident that the extension of banking is a matter of vital concern both of the monetary authorities and the government, for obvious reasons. To help a planned bank expansion, therefore, the Bank established in October, 1950, a new Department of Banking Development which was vested with the responsibility of promoting and assisting the expansion of banking facilities in the country.[1] The primary task of the Department was to implement the recommendations of the Rural Banking Enquiry Committee (1950) and the Informal Conference on Rural Finance (1951). The main recommendations were concerned with branch expansion by commercial banks in general and the Imperial Bank in particular.

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[1] *Ibid.*, pp. 56-57.

It is possible to take an optimistic view of the expansion of banking that took place under the general direction of the Reserve Bank during the period under study. The nationalization of the Imperial Bank of India in 1955, for instance, marked the beginning of a new era of accelerated and planned branch expansion program. Thus from its inception in July, 1955, up to the end of March, 1960, the State Bank of India (formerly the Imperial Bank) opened as many as 374 branches. Of these branches, 263 were opened at places with a population of 25,000 or less, that is in the rural and semi-urban areas which were seriously lacking in banking facilities. The Reserve Bank also took appropriate steps to encourage the opening of new branches by other banking companies, especially in the rural areas.

The achievements of the Reserve Bank in playing its developmental role may now be summarized. Since about the beginning of the period under study, the Reserve Bank began to operate on a new conception of its own developmental role in a planned economy. That conception was very different from the accepted functions of central banking. Furthermore it was often in conflict with its own restrictive role. The Reserve Bank's developmental role was not only desirable but became almost essential in the case of India. With the acceptance by the Indian government of the concept of development planning, the monetary policy was called upon to play a very difficult role. And the success of the monetary policy depended not only upon the ingenuity with which the policy was formulated but also upon the financial institutions within the framework of which the authorities had to function. It is therefore apt to conclude that with the implementation of the First Plan it became necessary for the Bank to deviate from the "norm" with a view to developing credit institutions and practices which helped the planned development.

While the Reserve Bank's new concept of central banking in the context of India's planning was a happy one, as mentioned above, it often created a conflict between its developmental role and the restrictive role, which posed a thorny problem. The development of credit institutions and advancing by the Bank of productive credit through these institutions generated inflationary pressures in the economy.

Such a situation only made the restrictive role of the Bank more onerous, which was to control the "new" inflation generated by the accelerated deficit financing. This situation duly emphasized the conflict in the development phase of an underdeveloped country that often arises between the "short run" and the "long run" objectives of monetary policy. The conflict could not be resolved by the sacrifice of the developmental role in favor of the restrictive role. For if through undue caution the Bank withheld legitimate credit for agricultural and industrial production, these areas might never have developed. In the ultimate analysis, therefore, the Bank could not help but endeavor to bring about a reconciliation between the two equally important aspects of its role: its developmental role of helping certain sectors of the economy in acquiring the requisite credit, and its restrictive role as the controller of credit expansion in the economy. Our study has demonstrated that the Bank was fairly successful in this reconciliatory task.

In conclusion, it is of prime importance to observe that a central bank necessarily functions within the freedoms and limitations set by the current economic philosophy of the country. If the dominant problem in a country like

India is one of development, and the effort of the entire country is directed toward the mobilization of the national resources so as to maximize the rate of development, there arises a new angle to central bank objectives, namely, the necessity for augmenting credit facilities and giving a purposive direction to credit. The development of this new angle should lead the Reserve Bank to reformulate the monetary policy in a way which would encourage the flow of credit into desired directions without necessarily bringing about a contraction in the total quantum of credit. Only in this way can the Bank achieve the dual objective of "controlled expansion," and help achieve the goals established by the society.

CHAPTER IX

SUMMARY AND CONCLUSION

This chapter is presented in the form of an epilogue -- a resume of chapters I through VIII. In doing so an attempt will be made to make the main points in sharper outline, although that will mean a sacrifice of the stress and emphasis which was possible in the detailed exposition of these points.

Epilogue

In chapter I entitled "Introduction" it was pointed out that in recent years there has been increased emphasis on the role of monetary policy in the accelerated economic growth of all nations in general, and of underdeveloped countries in particular. In this context the central bank assumes special importance primarily because it is called upon to formulate the monetary policy to help achieve the objective of economic development while maintaining the value of the national currency. An attempt was also made to justify the study of the economic problems of India in the context of her government-sponsored five year plans on the grounds that India provides a fascinating topic for such a study.

Chapter II began with a discussion of the meaning of economic development, and an attempt was made to formulate a suitable definition of economic development to describe the underdeveloped nations. It was observed that a precise definition was difficult. However, certain basic characteristics separated developed countries from the underdeveloped nations; and a discussion of some of these characteristics was then undertaken. Next, conditions prevailing in India were compared with the characteristics of underdeveloped countries, which clearly identified India as an underdeveloped country. Thereafter an attempt was made to determine the stage of economic development in India. It was found that India was in the Rostowian stage of "take-off." Finally, special problems of economic development facing India, such as problems of unemployment, small-scale industries, regional disparities, etc., were discussed.

An attempt was made in chapter III to describe the banking and monetary system in India. It was observed that India's banking and monetary system is one of the most highly developed aspects of the economy. In the banking sector the Reserve Bank acts as the central bank for appraximately 440 scheduled, exchange, and non-scheduled banks. The Bank occupies a particularly important place in the financial structure of the country. In addition to helping to provide agricultural and rural credit it has contributed to other types of long-term financing. The Banking Companies Act of 1949 granted the Bank extensive powers over the commercial banks, including authority to resort to selective controls and to regulate rates of interest charged by banks. The Reserve Bank enjoys cordial relations with the commercial banks, which have come to rely on it as a convenient source of advice and financial help. Attempts by the Bank to improve the monetary institutions were also mentioned. In this connection, a brief discussion of the method of credit expansion and contraction in India was undertaken. The legal note-issue provisions were also discussed. An analysis of the establishment of the Bill Market Scheme, which extended the scope of the Reserve Bank credit to banks, was also undertaken.

In the area of money and capital markets mention was made of such special features as indigenous bankers, cooperative credit societies, the managing agency system, and organized stock exchanges. It was emphasized that in India, as in other relatively underdeveloped countries, the pressing need is for long-term capital to facilitate more rapid industrialization. Specialized institutions for providing long-term capital, such as exist in developed countries of the West, are largely absent in India. Other important developments in the money and capital market region were also mentioned.

Chapter IV was a factual account of the economic development that took place in India during the period 1950-51 to 1959-60. It was observed that in terms of national and per capita incomes, production, investment, and savings, the economic gains of the First Plan were much higher than the gains of the first four years of the Second Plan. The salient features of the two government-sponsored plans were also given in this chapter.

A versatile and percipient central bank in an underdeveloped country develops new techniques of monetary management and uses the instruments of credit control in a flexible manner to cope with new problems, such as increasing public debt, the changing role of government in economic activity, changing balances within the economy and so on. This was particularly true of the Reserve Bank, as was revealed in chapter V, which provided a historical perspective of the monetary management in India. During the period under study the Bank used all the instruments of credit control available to it. Also the Bank relied more heavily upon selective controls during the Second Plan when inflationary pressures began to mount, and the character of inflation began to take a different form.

In chapter VI an attempt was made to build a theoretical model in terms of which the monetary policy in India was to be evaluated. It was observed that inflationary pressure is an inevitable result of the accelerated investment required by a program of economic development insofar as it is not financed by internal savings and/or foreign aid. The inflationary pressure, or "money inflation," develops into inflation, or "true inflation," only when it is not offset by monetary-fiscal measures, direct controls, or import surpluses. Thus governments of underdeveloped countries aiming at rapid industrialization are not likely to find it possible to avoid inflationary pressure since this in many cases would mean the abandonment of development itself; the appropriate anti-inflationary policies may, however, enable them to avoid any serious inflation engendered by economic development.

In the context of the inflation generated by the development process a distinction was made between money inflation and true inflation. It was observed that prices may rise due to fluctuations in consumption, investment, and government use of resources. Such an increase in prices is induced by real factors; it is independent of changes in money supply and serves to guide production, distribution, and the use of the national output in a manner leading to economic development. This rise in prices is to be identified with money inflation. Money inflation should not be confused with true inflation, which leads to a persistent price rise without a simultaneous increase in production (with a time lag), and in a manner that retards economic development in the long run. It is true inflation that should cause concern in the minds of the monetary authorities in a developing economy.

It was further emphasized that an absolute emphasis on price stability is inconsistent with the rapid economic development of an underdeveloped economy. In fact, certain amounts of credit creation and expansion of credit facilities are necessary conditions of economic development. Besides, in an economy moving toward steady growth, the effective demand and also the price level must increase. A moderate though not necessarily continuous rise in prices is likely to have beneficial effects on the process of development itself. It may, for instance, provide a greater incentive to, and a source of finance for, greater private investment. What is important for the monetary authority to recognize, however, is that on the one hand money inflation to a certain degree is beneficial to economic development and, on the other, pure inflation in the form of a general and sustained price increase leading to a depreciation in the value of the currency is detrimental to the cause of development. A credit policy directed towards moderating the latter form of inflation would therefore be the prerequisite to a sustained economic development. This would suggest that monetary policy will have to be flexible enough to cope with the changing situations and phases of development.

Finally, in this chapter a distinction was made between the restrictive and developmental roles of monetary policy. Essentially, the efforts of the monetary authorities to control the new inflation generated by the accelerated development process are called the restrictive role of monetary policy. On the other hand, the developmental role of monetary policy is to develop financial institutions conducive to rapid economic development.

In chapter VII, a critical evaluation of the restrictive role of monetary policy was undertaken. After a detailed analysis it was shown that during the First Plan the economy did not experience any major inflationary pressures, due primarily to the cushion of food supply available in the economy. Inflation began to exert its pressure on the economy after the inauguration of the Second Plan in 1956 and, by the end of March, 1960, assumed serious proportions. However, the increased production of foodgrains mitigated the inflationary pressures to a certain degree. The Reserve Bank initiated a "new" monetary policy in 1951, made its policy somewhat rigorous and flexible in 1956, and simultaneously resorted to selective credit controls extensively as an anti-inflationary measure. However, the Bank only had a partial success. This was qualified by pointing out that, since the "new" inflation generated by the rapid pace of economic development was primarily the consequence of heavy deficit financing by the government of India, the Reserve Bank was not to assume responsibility for the true inflation generated in the economy.

In chapter VIII the developmental role of monetary policy was evaluated. It was recognized that the Reserve Bank played this role fairly successfully; however, there was still no room for complacency, since what had been done only emphasized the great deal that had yet to be accomplished. In the end, it was observed that occasionally there arose a conflict between the developmental and the restrictive roles in the Indian context. This was a thorny problem to which an exact answer appeared impossible. And even if it were possible, such an answer could be considered valid only for particular times and phases of development.

Conclusion

In recent years monetary policy has been regaining the prestige that it lost during the nineteen thirties. During the Great Depression, which no doubt called for unorthodox remedies, monetary orthodoxy was progressively abandoned and even became to some extent discredited. Then during the war years most countries found that the discipline which was required of their economies was so great that it had to be imposed by means of direct controls rather than by broader monetary measures. Immediately after the war there was a strong tendency in Europe and elsewhere to perpetuate controls and to reject monetary policy as an instrument for attaining internal and external economic order. The first country to break this pattern was Germany, whose economic recovery was spectacular owing primarily to the sound management of the new German currency.[1] Germany was followed by other European nations, such as Italy and Austria, which provided striking examples of how vigorous economic growth could be achieved even in relatively weak countries with the right brand of economic, and especially monetary, policy.[2]

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[1] For instance, see B. R. Shenoy, "West German Recovery," Times of India, September 25, 1959.

[2] It may be noted that the country where inflation was most deeply rooted was France, which had to await a major constitutional overturn before coming to grips with its devastating economic ills. Under President DeGaulle the "Report on the Financial Situation of France" was prepared by Jacques Rueff. Rueff emphasized that the principal ill of the French economy had been excessively resorting to the creation of money for both public and private purposes, and he held out no hope of recovery until the tap of inflation was turned off tight. Indeed, his report set forth the following specific principles of a reform strategy for France: (1) relieving inflation by saving, (2) breaking the inflationary cycle, (3) establishing with certainty that the inflationary process was over, (4) substituting elasticity by investment for elasticity by inflation. See J. B. Knapp, "Threat of Inflation in the Underdeveloped World," Stanford: Privately Printed, 1959, p. 2. (Speech delivered at the Eighteenth Stanford Business Conference at Stanford University, July 19-22, 1959.)

In the postwar era the underdeveloped world has been facing a recovery problem of a different character. The governments of almost all the underdeveloped countries in Asia, Africa, and Latin America are under the strongest compulsion to accelerate their economic development in order to improve the standards of living of their people. However, unlike the advanced nations, they lack experience, trained personnel, and sometimes the resources which are a prerequisite to sound economic development. They have therefore the temptation to try to develop their nations quickly without proper regard to the devastating consequences for their economic systems. This situation is undoubtedly fraught with most serious danger.

Experience shows that in almost all cases the root of the trouble lies in a deficit in the governmental budget which is financed by the creation of new money. The government may be spending too much because it is attempting to overreach itself, or because what it is attempting is done inefficiently. It may also be that the government may be failing to collect sufficient revenues, either because the tax structure is inadequate or because the laws are not properly enforced. It should of course be recognized that the possibilities open to the government of an underdeveloped country to raise additional internal revenues are strictly limited. For it requires political courage to levy higher taxes. Besides, one of the things characteristically least developed in such a country is its capital market. The institutions for collecting the savings of the people are often rudimentary, the credit of the government may not be well established, and, finally, the currency may be depreciating so that long-term obligations are difficult to sell. If the government cannot successfully borrow from the public it is left with the only alternative (except for attracting foreign aid) of financing the development through a kind of "forced saving," that is, forcing depreciating money into the hands of the public mainly by demanding that the banking system create new money for its purposes. Whether this takes the form of outright currency printing by the central bank or the more subtle creation of commercial bank credit, the result is to give a further impetus to the inflationary mechanism.

The problem may now be posed in terms of the current economic context in India. The government of India, like other underdeveloped countries, is anxious to embark on accelerated development plans in order to reach the stage of "drive to maturity" within the shortest possible time. Obviously the internal resources are short of the financial requirements of the government-sponsored five year plans that are now being implemented. Consequently the government has to resort to the well-known method of deficit financing, through the creation of central bank credit. This method of financing is inflationary in character, and the Reserve Bank is called upon to play the role of a "controller of inflation." In fact, with slight modification Senator Douglas' analogy applies in the case of the Bank. The task of trying to check inflation while extending credit, according to Douglas, "will be just as futile as when I fill this glass of water and keep pouring it in, and then try to mop up the overflow with a pocket handkerchief."[1]

To sharpen the issue two fundamental factors characterize the role of the Reserve Bank in the economic development of India.[2] First, India has an economy of planned development, and the central banking policy has to adjust itself within the framework of the Plan. Second, the size and structure of the Plan are primarily decided upon not on the basis of the available resources of the country, but on the basis of the determination of the body politic to formulate plans of large dimensions. Once the size of the Plan is agreed upon, the Government has to resort to deficit financing for the reasons mentioned above. This is more than likely to create inflationary situations, and the Bank has necessarily to function within the condition created by the effort to carry out the Plan.

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[1] P. A. Douglas, Hearings before the Sub-Committee on General Credit Control and Debt Management of the Joint Committee on the Economic Report, Congress of the United States, 82nd Congress, Second Session, Washington, 1952, p. 22.

[2] This view is also taken by the Reserve Bank. See H. V. R. Iengar, "Some Reflections on Our Domestic Economy," op. cit., p. 12.

The primary responsibility of the monetary authorities of an underdeveloped country like India is to reduce the pressure of monetary demand without at the same time hampering production, so as to help maintain the rapid pace of development. It has been reiterated on numerous occasions by the Reserve Bank that the aim of the Bank is to "keep inflationary pressures at bay while the production forces are gathering momentum."[1] It should be recognized that an attempt to provide adequate finances for encouraging production on the one hand, and to control the inflation generated by the expansion in the money supply on the other, makes the task of the Bank all the more difficult. Nevertheless the nature of the problem of the development of India, at least in the initial stages, is such that aiming at one of the above objectives at the cost of the other would only be self-defeating. Consequently the monetary policy has of necessity to assume this dual responsibility.

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[1] Reserve Bank of India Bulletin, (November, 1960), p. 1611.

In conclusion it may be said that this study has pointed out clearly that the inflation which was generated in the economy towards the end of the First Plan and continued unabated through the Second Plan, undermined the gains of development. However, the monetary authorities were not to bear the blame. The two main factors contributing to the intensification of the inflationary pressures were, first, the failure of the agricultural production to rise along with an increase in the money supply, and second, the heavy deficit financing undertaken by the government. The first factor was non-monetary and hence outside the jurisdiction of the monetary authorities. The second factor was the sole concern of the government and could not be controlled by the Reserve Bank. In fact it might not be wrong to say that in India monetary policy was subordinated to fiscal policy.[1]

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[1] Note, for instance, the comments recently made by the Governor of the Reserve Bank. He said: "The determination of fiscal policy is not a matter in which Government

It follows therefore that, since the monetary authorities were obliged to act as the prime source of monetary expansion in the Indian economy by extending the requisite amount of credit to the government, and since monetary policy was called upon to play a "passive role," the blame rested primarily on the government, which directed the "total economic policy" of the country. This is the thesis of this study.

Finally, it may be pointed out that the task that the Reserve Bank set out to do was a difficult one. Acting as the credit-creating machine while at the same time restricting the effects of excessive credit creation is a

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is or can always be guided by the advice of the Reserve Bank. Fiscal policy includes taxation policy . . . the formulation of specific tax measures -- their selection, magnitude and timing is a question within the sole competence of Government. The determination of Government policies in so far as the preservation of monetary stability is concerned is not confined merely to the field of taxation or budgetary deficits or surpluses but extends also to the field of administration . . . . It would be manifestly absurd to ask that . . . Government must necessarily ask for the advice of the Reserve Bank. Sometimes, advice is asked for . . . but . . . there is . . . an area which is very clearly the direct concern of Government." H. V. R. Iengar, "Monetary Stability and the Role of the Reserve Bank," op. cit., p. 1610. Similar views were expressed in an official publication of the Reserve Bank. Thus, "It should, however, be emphasized that in practice the regulation of money supply is not wholly or even largely under the Bank's control. It is considerably affected by the budgetary operations of the Government, over which the Bank has no control . . . ." See Reserve Bank of India, Functions and Working, [illegible], p. 11.

thorny problem, and no panacea can be suggested that would work under all circumstances. To say this is to reiterate the familiar observation that central banking is an art rather than a science. The ultimate success of monetary policy, in India or in any other underdeveloped country, will depend in large measure upon the skill and open-mindedness of the monetary authorities to adapt constantly the technique of central banking to the everchanging economic situations in the country. And in the final analysis such versatility of the central bank would depend to a large extent upon the recognition and evaluation of the critical studies of its policy made by the public. This study has been such a one.

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BIOGRAPHICAL SKETCH

Siddheshwar Mittra was born on May 13, 1930, at Banaras, India. In April, 1945, he was graduated from St. John High School, Agra, India. In April, 1951, he received the degree of Master of Commerce from Agra University. From 1951 to 1957 Mr. Mittra worked with the Reserve Bank of India in a research capacity. In September, 1957, he enrolled in the graduate school of the University of Florida. He worked as a graduate assistant in the Department of Economics until August, 1959, and as a teaching assistant until August, 1960. From September, 1960, to August, 1961, he taught at Stetson University, Deland, Florida. Since September, 1961, until the present time he has taught at the University of Florida.

Mr. Mittra is married to the former Bani Sarkar. He is a member of the American Economic Association and the Indian Economic Association.

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February 3, 1962

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